BEFORE

THE PUBLIC SERVICE COMMISSION OF

SOUTH CAROLINA

DOCKET NO. 2002-223-E - ORDER NO. 2003-38

JANUARY 31, 2003

IN RE: Application of South Carolina Electric & Gas Company for an Increase in its Electric Rates and Charges	)))	ORDER APPROVING ELECTRIC RATES AND CHARGES

I.

INTRODUCTION

This matter is before the Public Service Commission of South Carolina ("Commission") on the Application of South Carolina Electric & Gas Company ("SCE&G" or the "Company"), filed August 6, 2002, for adjustments in the Company's electric rates and tariffs, and for certain changes in the Company's General Terms and Conditions for service. The Application was filed pursuant to *S.C. Code Ann.* §§ 58-27-820, 870 (1976, as amended) and *S.C. Code Regs.* 103-834 (as amended) (South Carolina Public Service Commission Rules of Practice and Procedure).

The Company's rates and tariffs were approved by the Commission in Order No. 96-15, issued January 9, 1996, in Docket No. 95-1000-E. Subsequently, the Commission ordered a prospective rate reduction for the Company of $22.699 million annually, in Commission Order No. 98-987, Docket No. 98-623-E. The rates and tariffs as requested in the Company's Application in the present docket would produce an increase in annual revenues of approximately $104.7 million and provide a return on common equity of 12.5%, according to the Company's calculations.

By letter, the Commission's Executive Director instructed the Company to cause to be published a Notice of Filing and Hearing in newspapers of general circulation in the area affected by the Company's Application. The Notice of Filing and Hearing indicated the nature of the Company's Application and advised all interested parties desiring participation in the scheduled proceeding of the manner and time in which to file appropriate pleadings. The Company was also required to directly notify all customers affected by the proposed rates and tariffs. The Company furnished affidavits demonstrating that the Notice was duly published in accordance with the Executive Director's instructions and certified that a copy of the Notice was mailed to each affected customer.

Petitions to intervene were received from the Consumer Advocate for the State of South Carolina ("Consumer Advocate"), the United States Department of the Navy ("Navy"), John D. Ruoff, Ph.D., *pro se* ("Dr. Ruoff"), South Carolina Merchants Association ("SCMA"), S.M.I. Steel-South Carolina ("SMI"), South Carolina Energy Users Committee ("SCEUC"), South Carolina Small Business Chamber of Commerce ("SCSBCC"), and Wal-Mart Stores, Inc. ("Wal-Mart").

The Commission Staff made on-site investigations of the Company's facilities, audited the Company's books and records, and gathered other detailed information concerning the Company's electric operations. The Consumer Advocate, Navy, Dr.

Ruoff, SCMA, SMI, and SCEUC likewise conducted extensive discovery. SMI withdrew its intervention prior to the commencement of the hearing in this matter.

A public hearing was held in the offices of the Commission from November 18 through November 22, 2002. The Honorable Mignon L. Clyburn presided. SCE&G was represented by Catherine D. Taylor, Esquire, Belton T. Zeigler, Esquire, and Francis P. Mood, Esquire. The Consumer Advocate was represented by Hana Pokorna-Williamson, Esquire, and Elliott F. Elam, Jr., Esquire. The Navy was represented by Audrey J. Van Dyke, Esquire, and Marilyn Johnson, Esquire. SCMA was represented by Robert E. Tyson, Esquire. SCEUC was represented by Scott Elliott, Esquire. SCSBCC was represented by Joseph M. Epting, Esquire, and Joseph M. Epting, Jr., Esquire. Frank R. Ellerbe, III, Esquire, represented Wal-Mart. Dr. Ruoff appeared *pro se*. The Commission Staff was represented by F. David Butler, General Counsel.

The Company presented the direct and rebuttal testimony of Neville O. Lorick, its President and Chief Operating Officer; Kevin Marsh, its Senior Vice President and Chief Financial Officer; Carlette L. Walker, Assistant Controller of SCANA Corporation's regulated subsidiaries, including SCE&G; John R. Hendrix, Supervisor of Electric Pricing and Rate Administration, SCANA Services, Inc.; Julius A. Wright, Ph.D., President of J. A. Wright & Associates, Inc.; Thomas R. Osborne, Managing Director Global Energy and Power Group, Investment Banking Department, UBS Warburg, LLC; and Burton G. Malkiel, Ph.D., Chemical Bank Chairman's Professor of Economics at Princeton University. The Company presented direct testimony only of James M. Landreth, its Vice-President of Fossil and Hydro Generation.

The Consumer Advocate presented the testimony of Glenn A. Watkins, Vice President and Senior Economist of Technical Associates, Inc., and David C. Parcell, Executive Vice-President and Senior Economist, Technical Associates, Inc. Mr. Parcell's testimony was jointly sponsored with SCMA. SCMA, in addition to Mr. Parcell, presented the direct and surrebuttal testimony of Kevin C. Higgins, a principal in the firm of Energy Strategies, LLC, and James M. Herritage, President of Energy Auditors, Inc. SCMA also presented the direct testimony of Chris Schell, Manager of Construction, Energy and Environmental Services for BI-LO Stores, Inc. SCEUC presented the testimony of Nicholas Phillips, Jr., a principal in the firm of Brubaker & Associates, Inc., and Michael Gorman, a consultant with the same firm. SCSBCC presented the testimony of Timothy C. Wilkes, CPA, Chairman of the Board of Directors of that organization. Wal-Mart presented the testimony of James W. Stanway, Director of Project Development for that company. The Navy presented the direct and surrebuttal testimony of Donald B. Coates, a public utility specialist with the Navy's Rate Intervention Office. The Commission Staff presented the testimony of Thomas L. Ellison, PSC Audit Manager I; A. R. Watts, Chief of Electric, PSC Utilities Department; Eddie Coates, Rates Analyst, PSC Utilities Department; and James E. Spearman, Ph.D., the Commission's Research and Planning Administrator. Dr. Ruoff presented no witnesses.

The Commission also heard from four public witnesses: Robert L. Slimp, Ralph Lewis, John W. Casey, and Reginald Troutman Miller.

II.

FINDINGS OF FACT

Based upon the Application, the testimony, and exhibits received into evidence at the hearing and the entire record of these proceedings, the Commission makes the following findings of fact:

1. SCE&G is an electric utility operating in 24 counties in the central and southern areas of South Carolina, where it is engaged in the generation, transmission, distribution and sale of electricity to the public for compensation. SCE&G's retail electric operations in South Carolina are subject to the jurisdiction of the Commission pursuant to *S.C. Code Ann.* § 58-27-10, *et seq.* (1976, as amended). SCE&G's wholesale electric operations are subject to the jurisdiction of the Federal Energy Regulatory Commission (FERC). In addition to its electric operations, SCE&G also provides natural gas services, subject to the jurisdiction of the Commission pursuant to *S.C. Code Ann.* § 58-5-10, *et seq.* (1976, as amended).

2. The appropriate test year period for the purposes of this proceeding is the twelve-month period ending March 31, 2002.

3. The Company sought at the onset of the hearing, an increase in annual revenues of $104.7 million.

4. The appropriate operating revenues for the Company's retail operations for the test year under present rates and after accounting and *pro forma* adjustments are $1,228,169,000.

5. The appropriate operating revenues for SCE&G's retail operations under the approved rates are $1,298,873,000 which reflect a net authorized increase in operating revenues of $70,704,000.

6. The appropriate operating expenses for the Company's retail operations for the test year under its present rates and after accounting and *pro forma* adjustments are $964,541,000.

7. The appropriate operating expenses for the Company's retail operations under the approved rates are $986,796,000.

8. The Company's reasonable and appropriate federal and state income tax expense should be based on the use of a 35% federal tax rate and a 5.0% South Carolina tax rate, respectively.

9. The Company's appropriate level of net operating income for return for the test year under present rates, and after accounting and *pro forma* adjustments is $266,396,000 for SCE&G's retail operations, including customer growth of $2,768,000.

10. The appropriate net income for return under the rates approved and after all accounting and *pro forma* adjustments is $315,354,000 for retail operations, including customer growth of $3,277,000.

11. A year-end original cost rate base of $3,174,083,000 for retail operations consisting of the components set forth in Table B of this Order shall be adopted.

12. The capital structure utilized by the Commission in this proceeding for the determination of the fair overall rate of return is the capital structure of South Carolina Electric & Gas, updated to September 30, 2002, and adjusted to include $150,000,000 in

equity securities issued on October 16, 2002. This consists of 43.41% long-term debt, 4.41% preferred stock, and 52.18% common equity.

13. The embedded cost rate for long-term debt of 7.23% and the embedded cost rate for preferred stock of 6.81% as of September 30, 2002 have been used in the determination of the fair overall rate of return approved herein.

14. The fair rate of return on common equity which SCE&G should be allowed the reasonable opportunity to earn is 12.45%, which is the rate of return adopted by the Commission for this proceeding. The capital structure and cost of capital which the Commission has approved herein produce an overall rate of return of 9.94% for SCE&G retail electric operations as depicted in the following table:

TABLE A

COMPONENT OF CAPITAL STRUCTURE	RATIO %	EMBEDDED COST/RATE %	OVERALL COST/RATE %
Long Term Debt	43.41	7.23	3.14
Preferred Stock	4.41	6.81	.30
Common Equity	52.18	12.45	6.50
	100.00		9.94

15. The rate designs and rate schedules approved by the Commission and the modifications thereto as described herein are appropriate and should be adopted.

16. The proposed changes in the Company's General Terms and Conditions for service, including proposed reconnection charges, are unreasonable, and as discussed hereinafter, should be denied at this time.

17. By its Order No. 1999-655 in Docket No. 1999-389-E, the Commission has allowed the Company to accelerate depreciation of its Cope Generating Station, at its

discretion, when revenue or expense levels warrant. This mechanism will expire on December 31, 2002, unless extended by the Commission. The Company has requested such an extension until December 31, 2005. The Commission finds that the justifications for its decision in Order No. 1999-655 are still reasonable and prudent and such extension should be allowed.

III.

EVIDENCE AND CONCLUSIONS

The evidence and conclusions supporting the findings of the Commission in this matter are as follows:

A. EVIDENCE AND CONCLUSIONS CONCERNING THE COMPANY'S BUSINESS AND LEGAL STATUS

(FINDING OF FACT NO. 1)

The evidence supporting the finding concerning the Company's business and legal status is contained in the Company's Application and in prior Commission Orders and docket files of which the Commission takes judicial notice. This finding of fact is essentially informational, procedural, and jurisdictional in nature, and the matters it involves are uncontested.

B. EVIDENCE AND CONCLUSIONS CONCERNING THE TEST PERIOD (FINDING OF FACT NO. 2)

The evidence for this finding concerning the test period is contained in the Application of the Company and the testimony and exhibits of Company witness Carlette L. Walker (Tr., Vol. II, Walker, at.361) and Staff witness Thomas L. Ellison (Tr., Vol. V, Ellison, at 1455). A fundamental principle of the ratemaking process is the establishment of a test-year period. Reliance upon the test year concept, however, is not designed to preclude the recognition and use of other historical data which may precede or post date the selected twelve month period where it is appropriate to do so.

Integral to the use of a test year is the necessity to make normalizing adjustments to the historic test-year figures. Only those adjustments which have reasonable and definite characteristics and which tend to influence reflected operating expenses are made in order to give proper consideration to revenues, expenses, and investments. *Parker v. South Carolina Public Service Commission*, 280 S.C. 310, 313 S.E.2d 290 (1984). Adjustments may be allowed for items occurring in the historic test year but which will not recur in the future, or to give effect to items of an extraordinary nature by either normalizing or annualizing such items to reflect more accurately their annual impact, or to give effect to any other item which should have been included or excluded during the historic test year. The Commission finds the twelve months ending March 31, 2002, to be the reasonable period on which to make its ratemaking determinations.

C. EVIDENCE AND CONCLUSIONS CONCERNING REVENUES, EXPENSES AND INCOME

(FINDINGS OF FACT NOS. 3-10)

1. DEPRECIATION

We deny the new depreciation rates proposed by SCE&G, which were based on a new depreciation study submitted by SCE&G. Company witness Walker, who sponsored the new depreciation study, was not familiar with the details of the study, and could not answer relevant questions related to the study's preparation, portions of the study related to plant investment, account retirement patterns, or other methodologies contained therein. *See* Tr., Vol. II, Walker, at 430-432. Indeed, the witness stated specifically that she was not familiar with the specifics and details of the study, which was why the Company had hired a consultant. Id. at 431. The Company did proffer the consultant's testimony. However, this does not constitute evidence in this case. Accordingly, although we decline to strike the study from the evidence of this case, we will not give it any weight, and we therefore deny the new depreciation rates proposed by the Company. We will consider such matters as this on a case-by-case basis in future proceedings.

2. CHARLESTON AND COLUMBIA FRANCHISE AGREEMENTS

(a) FACTS

In 1996 and 2002, the Company successfully negotiated 30-year franchises for the provision of electric and gas services within the cities of Charleston and Columbia, respectively. By the testimony of Mr. Lorick (Tr., Vol. I, Lorick at 40-44; Vol. V at

1655) and Dr. Wright (Tr., Vol. IV, Wright, at 993-97; Vol. V, at 1720), the Company established the essential nature of these two service areas to its system and to all of its customers. The population of these two municipalities accounts for approximately 17% of the system's customer base. (Tr., Vol. I, Lorick, at 43). Charleston and Columbia are the two largest and most densely populated cities in SCE&G's service area and, also, represent areas of growth in the service area. (*Id.*). As these witnesses testified, it is self-evident that the loss of significant service rights in either of these municipalities would have a devastating effect on the system. (*Id.*). Both of these franchises were sufficiently at risk to justify the negotiation of the new agreements. (Tr., Vol. I, Lorick, at 43-45; Vol. IV, Wright, at 994-5).

As to the City of Charleston, SCE&G, or its predecessors, have provided utility services for over one hundred years. The existing franchise with that city had expired, necessitating the negotiation of a new agreement. After several extensions of the old agreement, the new, thirty-year agreement was entered into in 1996. (Tr., Vol. I, Lorick, at 44).

As to the City of Columbia, the Company, and its predecessors, have provided utility services for decades as reflected in the opinion of the South Carolina Supreme Court in *State ex rel. Daniel, Attorney General v. Broad River Power Co.,* 157 S.C. 1, 153 S.E. 537 (1929). (*Id.* at 41). In recent years, the relationship between the City and the Company had deteriorated to the extent that the City was seriously considering municipalization of the electric system and retained a consultant for this purpose. (*Id.* at 44).

Integral components of the franchise relationships in both cities were the public transit systems owned and operated by the Company. (*Id.* at 41). As a part of the new agreements, the Company was able to cease public transit operations and divest itself of these utility functions. (*Id.* at 45). In Docket Nos. 96-281-E and 2002-145-E, respectively, the Commission approved the conveyance of the Company's transit and other assets to the cities of Charleston and Columbia and the cessation of transit operations in those cities by the Company.

Since these transit transfers were integral to the Company's obtaining the thirty-year franchise agreements and attendant franchise rights, the Company took the position in its application that the costs of such franchises should be borne by the Company's electric ratepayers. Historically, however, the operating losses resulting from the transit systems have been absorbed by the Company's shareholders. (*Id.* at 90). The protracted efforts of the Company to address transit rates, routes, and earnings (or lack thereof) were referenced by Dr. Ruoff, and the Commission has taken judicial notice of those proceedings. (*Id.* at 107-108). These proceedings need not be addressed in more detail here. Suffice it to say that the issue between the Company, on the one hand, and Intervenors addressing this issue, on the other, is the appropriate determination of the costs of these franchises to the Company. Since the hearing in this matter, Dr. Ruoff and the Consumer Advocate have negotiated with the Company a compromise proposal for the Commission's consideration, in which there is a sharing of the franchise costs in a way that recognizes the benefits of the franchises to the customers system-wide, while, at the same time, acknowledges the historic treatment of transit operating losses. The specifics of the proposal are set forth hereinafter. The testimony of Company witnesses Mr. Lorick and Dr. Wright amply support the findings of the Commission on this issue. (Tr., Vol. V, Wright, at 1735-37).

(b) CHARLESTON AND COLUMBIA FRANCHISES STIPULATION

The Commission has always encouraged the discussion and possible settlement of issues among parties, subject to the Commission's review and approval of such settlements as comporting with sound regulatory principles and being reasonable and prudent in their terms. Following the hearing in the matter, discussions were held by and among counsel for the Company, counsel for the Consumer Advocate and Dr. Ruoff. It was Dr. Ruoff who addressed in detail in these proceedings the issue of recovery of costs related to the Company's thirty-year franchise agreements with Charleston and Columbia. As a result of these discussions, a Stipulation was entered into by and among these parties as a recommendation to the Commission. The relevant language is as follows:

> The Company's proposed rate increase in Docket No. 2002-223-E reflected the inclusion of $45.2 million in rate base and $1.9 million in amortization expense related to 30-year electric franchises in the cities of Columbia and Charleston. The total retail revenue requirement associated with the franchises, which provides both a return of and a return on the amount in rate base, is approximately $8.0 million annually.
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> The parties agree that the Company should be allowed to amortize the franchises at the rate of $4.0 million annually while foregoing a return on the unamortized balance. In this manner, the retail revenue requirement is reduced by approximately $4.0 million. The amortization will be applied proportionately to the remaining balance of each franchise and shall remain in effect until all amounts related to the franchises have been written off. The amount of the franchise for the City of Columbia will

> include cash payments that will be made to the City through 2009 under the terms of the Conveyance Agreement, amounts necessary to match Federal grants for new buses, the net book value of various assets transferred to the City and costs to be incurred in the future for improvements and modifications to the Columbia Canal Hydroelectric Project required by the Federal Energy Regulatory Commission pursuant to the renewal of the project's operating license. The amount of (the) franchise for the City of Charleston will be as currently reflected on the Company's books and records.
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> As approved in Docket Nos. 96-281-E and 2002-145-E, the Company has accounted for the costs of the franchises in Electric Plant in Service, Account 302 - Franchises and Consents. In light of the proposed cost recovery treatment, it is more appropriate that the balances be transferred to Account 182.3 - Other Regulatory Assets. The parties agree that the Commission should allow the Company to account for the balances related to the Columbia and Charleston franchises in Account 182.3.

The Commission finds the stipulated proposal to be a reasonable, fair, and equitable treatment of the costs associated with the Charleston and Columbia franchise agreements. Accordingly, the stipulation is hereby approved.

3. GRIDSOUTH RTO COSTS

The testimony of Company witnesses Mr. Lorick and Dr. Wright recount a history of the actions of FERC as it pertains to the creation and ultimate suspension/termination of GridSouth Regional Transmission Organization ("RTO"). (Tr., Vol. I, Lorick, at 46-50; Vol. V, Wright, at 1707-15). For purposes of this Order, the relevant facts are briefly summarized as follows.

On December 20, 1999, FERC issued its Order No. 2000 which required utilities regulated by that agency to file a plan to join or form an RTO that would be operational by December 15, 2001, or provide an explanation as to why this could not be accomplished. (Tr., Vol. I, Lorick, at 46; Vol. V, Wright, at 1707). FERC clearly signaled that companies not joining an RTO would be subject to substantial penalties, including possible loss of their ability to sell power at market rates in the wholesale markets. (Tr., Vol. V, Wright, at 1707-08). At the time of its Order 2000, FERC's approach to RTO's allowed for variation in their structure and function to meet local concerns and interests. (*Id.* at 1708). As a result of that order, a number of utilities undertook complying efforts, among them, SCE&G, Duke Power, and Carolina Power & Light Company (CP&L), who joined efforts to form GridSouth RTO. (Tr., Vol. I, Lorick, at 47). Their objective, in addition to FERC compliance, was to develop an RTO focused on the customer and system needs of the Carolinas. (*Id.*). The companies made their GridSouth filing with FERC on October 16, 2000, and FERC gave conditional approval for the RTO in March, 2001. *Carolina Power & Light Co.,* 94 FERC ¶ 61,273 (March 14, 2001 Order). (Id. at 48; Vol. V, Wright, at 1709). In this order, FERC provisionally approved GridSouth as a for-profit RTO, operating in North and South Carolina, which could eventually own its transmission assets. FERC also provisionally approved organizational documents under which the participating utilities would manage the formation of GridSouth. The "provisional approval" indicated the fact that FERC was requiring that the original GridSouth documents be refiled with limited changes to reflect matters decided in the March 14, 2001 Order. (Tr., Vol. V, Wright, at 1709-11).

During the summer of 2001, a leadership change at FERC resulted in a dramatic change in that agency's RTO regulatory objectives. *See e.g. Regional Transmission Organizations, Order Initiating Mediation,* FERC ¶ 61,066 (2001), *n.b.* the concurring opinion of Commissioner Massey. As a consequence of this change in policy, the formation of GridSouth was no longer consistent with FERC regional transmission objectives, and, on June 18, 2002, the three participating utilities suspended this project. (Tr., Vol. I, Lorick, at 48-9; Vol. V, Wright, at 1711-15). However, the utilities' action could also be interpreted as a termination. It is unclear at this juncture. Although FERC issued an Order provisionally accepting the formation of the RTO as a "good first step," there remained the question of the independence of the RTO from its founders, SCE&G, Duke Energy, and Carolina Power & Light. Pursuant to various notices from FERC, GridSouth represented that it would limit its spending prior to the seating of an independent board for the RTO, which never took place.

In the present docket, the Company claims to have spent in excess of $13 million in activities associated with its share of the formation of the RTO. SCE&G is proposing to amortize the $13 million over 5 years. The annual retail revenue requirement impact under the Company's proposal is $3.35 million. See Tr., Vol. IV, Watkins, at 1058. We reject the Company's proposal.

First, most of the costs were incurred before the test year. Second, booked assets of GridSouth amounted to some $73.9 million as of July 31, 2002. Unfortunately, not much detail was provided by the Company as to the nature of its investment in the project. In fact, we believe that the Company has not met its burden for cost recovery at this time. See Tr., *Id.* at 1060; Tr., Vol. II, Coates, at 334. The Commission Staff agreed with this position in its Brief. See Post-Hearing Brief of the Commission Staff at 10. Further, the Staff testified that, since GridSouth was not operational during the test year, it should not have been considered used and useful during that time, although it might have been considered property held for future use. See Tr., Vol. V, Ellison, at 1490.

It should also be noted that FERC has made no determination as to how it will treat GridSouth expenditures at the wholesale level. Further, the costs involved were imposed as the result of FERC mandates. Accordingly, we agree with the position of the Staff in its Brief, which argues that it is premature to allow recovery of GridSouth costs at the retail level at this time. See Post-Hearing Brief of the Commission Staff at 10.

Finally, we agree with Staff that the door should remain open on this issue, and that allowance of GridSouth costs should be deferred until such time as the Company can meet its burden of proof, and/or until FERC rules on the allowance of the expenditures at the wholesale level. Id. at 10-11. It is understood that FERC could not consider the allowance of GridSouth expenditures at the wholesale level until this Commission has approved the transfer of functional control of transmission assets. At present, however, we reject the Company's proposal on GridSouth costs, for the reasons enumerated above.

4. BUY/RESELL TRANSACTIONS

The Company and Staff have proposed a *pro forma* adjustment to reduce test-year retail electric revenue and expenses to eliminate amounts related to certain wholesale power transactions. The transactions in question involved power traders working as agents for the Company who purchased power generated by third parties and then resold that power to third parties ("Buy/Resell Transactions"). (Tr., Vol. II, Walker, at 366). By Order effective October 1, 2001, the Commission had approved booking these revenues and expenses to non-regulated accounts. *See* Order No. 2002-74. The adjustment proposed by the Company and Staff here concerns amounts that were booked to regulated accounts before the effective date of that order. (*Id.*). No party to the proceeding has objected to this *pro forma* adjustment as such, and it is granted for the reason set forth in the testimony of Mrs. Walker. (Tr., Vol. II, Walker, at 366).

Instead, the Consumer Advocate's witness, Mr. Watkins, proposed that the Commission should allocate the net margins generated by these Buy/Resell Transactions 75% to ratepayers and 25% to the Company's unregulated accounts. He asserts that this is comparable to the treatment of certain transactions involving Piedmont Natural Gas Company authorized in Docket No. 2002-63-G.

The Commission, however, reaffirms its finding in Order No. 2002-74 and holds that Buy/Resell Transactions are indeed activities that are properly booked to unregulated accounts. The Commission finds that these transactions do not involve power generated by the Company's regulated utility plants. (Tr., Vol. II, Walker, at 391, 418). Accordingly, the revenues and expenses related to these transactions are not properly considered part of the Company's regulated activities or part of its provision of service to retail electric customers in South Carolina.

The Consumer Advocate's witness, Mr. Watkins, asserts that administrative costs related to these sales have been improperly billed to regulated accounts. (Tr., Vol. IV, Watkins, at 1082). His testimony is not based on a review of the actual accounts to which the costs were or were not billed but is based on a supposition based on his review of certain accounting orders. (*Id.* at 1055). In fact, Mrs. Walker, the Assistant Controller for SCE&G, testified that no such costs had been billed to regulated accounts. (Tr., Vol.

II, Walker, at 420). The Commission does not find credible evidence in the record to support the assertion that administrative or other costs related to these transactions have been improperly left booked in regulated accounts.

Mr. Watkins further asserts that recent precedent involving Piedmont Natural Gas Company requires that revenues and costs related to the Buy/Resell Transactions be "shared" between regulated and unregulated accounts. *See generally, In re Application of Piedmont Natural Gas Company*, Order No. 2002-671, November 1, 2002, at p. 77. The Commission, however, does not find the situation with Piedmont Natural Gas in Docket No. 2002-63-G to be analogous to the situation here.

Integrated electric utilities like SCE&G build and operate electric generating plants that serve most of their customers' needs. When they make opportunity sales from the output of those plants, this Commission typically has required 100% of the costs and revenues from those transactions to be booked to regulated operations.

Gas utilities, like Piedmont, do not produce their own gas, but instead purchase gas supply and gas transportation capacity on upstream pipelines. These "upstream assets" are purchased and held primarily to serve the utility's regulated customers. The cost of buying and holding these assets are paid by those customers. At times natural gas utilities like Piedmont may be able to resell some unused portion of these upstream assets in the open market. These sales are typically made on a limited term or recallable ("capacity release") basis with the underlying contracts remaining dedicated to serving retail customers.

The Commission is aware from its long history of regulating Piedmont that the sale of upstream assets involved in Docket No. 2002-63-G were sales such as described above. Because the assets underlying such sales were held to serve retail customers, a sharing of the risks and rewards related to their remarketing was appropriate.

The Buy/Resell Transactions at issue here are not analogous to the assets involved in Docket No. 2002-63-G. They are not part of a long-term portfolio of supply assets for which SCE&G's regulated customers bear the cost nor do they involve regulated generating assets in any way. (Tr., Vol. II, Walker, at. 391, 418). These are not transactions that are properly considered part of the Company's regulated activities or part of its provision of service to retail electric customers in South Carolina. Accordingly, the Commission finds that the costs and revenues related to these transactions are properly booked to unregulated accounts.

5. EMPLOYEE CLUBS

Through a *pro forma* adjustment, SCE&G has deducted from test year expenses and investment amounts related to its employee clubs.[1] (*Id.* at 367). It has done so by *pro forma* adjustments that have (a) removed operating and maintenance costs related to these clubs from retail electric O&M expenses and (b) removed the capital investments related to these clubs from retail electric plant in service accounts.

The Consumer Advocate's witness, Mr. Watkins, notes that in removing these costs the Company deducted 89.94% of the capital cost of the clubs from retail electric

[1] The Company has also agreed with the Staff that certain investment in Construction Work in Progress related to the clubs is properly removed from rates. That adjustment is one of the uncontested Staff adjustments referenced at the conclusion of this section of the order.

plant accounts and deducted 55.11% of the O&M expenses related to the clubs from retail electric operating and maintenance expense. (Tr., Vol. IV, Watkins, at 1057). Having noted this disparity, he proposes to apply the 89.94% allocation factor to both capital investment and O&M expenses. (*Id.*).

The Commission finds that in making adjustments to remove nonallowables, it is proper to remove the amounts initially allocated to regulated accounts, nothing more or less. Mr. Watkins provides no information to indicate that 89.94% of the O&M expenses related to employee clubs were initially allocated to retail electric expense, rather than the 55.11% that Mrs. Walker proposed to remove.

In this regard, the Commission does not find the fact of the disparity in allocation factors (89.94% vs. 55.11%) to be at all unusual. With a utility like SCE&G, it is not unusual that capital related items would be allocated at a proportionally greater rate to electric operations than would labor-related items, like employee benefits. The disparity in allocation reflects the fact that the capital investments for an electric and gas utility like SCE&G is disproportionately weighted to the electric side of the business where high-value generation investments, like the V. C. Summer Nuclear Station, are held. Employee headcounts, however, are typically more evenly divided between electric and non-electric activities. These facts would explain the difference in allocations.

The Commission notes that the Staff has audited the *pro forma* adjustments proposed by the Company and made revisions where required. (Tr., Vol. V, Ellison, at 1463). No revisions were proposed with relation to these allocations. For all these reasons, the Commission finds no credible basis in the record to deduct 89.94% of gross expenses related to employee clubs from allowable retail electric expenses, rather than the 55.11% that the Company proposed.

6. AT-RISK COMPENSATION PAY

The pay package SCE&G offers its employees includes both base pay and at-risk compensation. (Tr., Vol. II, Walker, at 368-69). As structured today, SCE&G's incentive pay program is based 50% on the achievement of company-wide financial goals and 50% on the achievement of annual business objectives. These business objectives concern such things as efficiency, quality of service, customer satisfaction, and progress towards strategic objectives. (Tr., Vol. V, Marsh, at 1682). Under this structure, incentive payouts vary from year to year depending on success in achieving these goals. The issue concerning incentive pay arises in this proceeding because there was no payout related to at-risk compensation during the test year. The record shows that at-risk compensation plans were in force during the entire test year. (Tr., Vol. II, Walker, at 368-69). But these plans contained minimum financial targets which SCANA was required to meet for there to be any payout. SCANA did not meet those minimum financial targets for 2001, and as a result, there was no pay out of at-risk compensation during the test year. (Tr., Vol. II, Walker, at 369).[2]

In its Application, the Company proposed a *pro forma* adjustment to include an amount equal to 50% of the target 2002 incentive pay in retail electric expenses. The

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[2] Because the decision not to pay incentives for 2001 was made during the test year, the Company reversed the accrual of the incentive by booking a credit equal to the entire amount of 2001 calendar year accruals. (Tr., Vol. II, Walker, at 369). The reversals made during the test year included January, February and March, 2001, which are periods prior to the test year. Both the Company and the Staff proposed to remove the reversals associated with those periods prior to the test year. The Commission finds that this adjustment is clearly appropriate as a means of returning test year incentive expenses to zero, and we approve the Staff's adjustment. (*See* Tr., Vol. V, Ellison, at 1466).

50% amount reflects the potential payout for 2002 that is not tied to Company financial performance. Instead, as the plan is now configured, 50% may be paid out based solely on the achievement of non-financial goals, and meeting financial goals is not a condition of the pay out. The record also shows that the Company, in fact, is accruing funds to pay incentive compensation for calendar year 2002 and "anticipates achieving these [incentive] goals and paying out 50% of the at-risk compensation." (*Id*).

The Commission Staff based a proposed disallowance of this adjustment on the fact that no incentive compensation was paid during the test year. (Tr., Vol. V, Ellison at 1465). The fact that no payout was made during the test year demonstrates that such expense is possibly non-recurring in future years. We disallow the Company's adjustment for at-risk compensation pay accordingly.

7. ADJUSTMENT FOR ANNUALIZING DEPRECIATION EXPENSE AND ACCUMULATED DEPRECIATION

As indicated above, it commonly occurs that the Commission must make *pro forma* adjustments to depreciation expenses in the process of setting rates. It has been the Commission's practice when making *pro forma* adjustments in depreciation expense also to make an adjustment to the level of accumulated depreciation on the Company's books. The past practice of the Commission has been to take 100% of the amount of the annualized *pro forma* adjustment to depreciation expense as a credit to depreciation reserves. This credit to depreciation reserves reduces the Company's rate base and lowers the amount of net plant on which the Company earns a return.

In her testimony, the Company's witness Mrs. Walker disagreed with this increase in depreciation reserves. (Tr., Vol. II, Walker, at 391-92). In the opinion of Mrs. Walker, this practice artificially increases the amount of depreciation reserves, thereby overstating the amount of depreciation the Company has actually recovered.

The booking of depreciation expense is the means by which utilities are allowed to recover the value of their investment in utility assets. As depreciation expenses are recovered, they are booked to depreciation reserves and reduce rate base by the amount of the original investment that has been recovered through rates.

In this case, the Commission accepts the Staff's adjustment of $296,000 to annualize depreciation expense on a retail basis. The offsetting adjustment to the depreciation reserve of $294,000 on a retail basis as proposed by Staff is also approved. The Commission agrees with the Staff that the proper accounting entry to record depreciation expense is to debit the expense account and credit the reserve account in the same amount. The Commission finds that a full rate base offset is proper since that represents the amount being recovered above the line in cost of service in this case.

8. URQUHART REPOWERING PROJECT

SCE&G completed the project to re-power two of its three Urquhart Station generating units in June of 2002 after the close of the test year. (*Id.* at 373). The Company's accounting witness, Mrs. Walker proposed several *pro forma* adjustments necessary to reflect this known and measurable out of period event. (*Id.* at 373-75).

(a) MISCELLANEOUS URQUHART PROJECT *PRO FORMA* ADJUSTMENTS

Concerning the Urquhart plant adjustments, there has been no opposition to the Company's proposed adjustments related to (a) plant in service and CWIP accounts, (b) depreciation and property tax expenses, and (c) maintenance related O&M expenses. (*Id.* at 373-74). However, the Commission Staff's witness, Mr. Ellison, has proposed certain revisions in the amounts of these *pro forma* adjustments, which the Company has not opposed. (Tr. Vol. V, Ellison, at 1471-72). The Commission finds that the completion of the Urquhart Station Repowering Project is a known and measurable event and that the above mentioned *pro forma* adjustments are appropriate to reflect this event in rates for the reasons stated in the testimony of Mrs. Walker and Mr. Ellison. The Commission further accepts Mr. Ellison's proposed changes in those adjustments as appropriate for the reasons stated in his testimony. (*Id.*).

(b) ADJUSTMENT TO INCLUDE FIXED PIPELINE CAPACITY CHARGES IN BASE RATES

As a result of the recent Urquhart Re-Powering Project, the two re-powered units now are fueled by natural gas. To provide gas supply to those units, SCE&G has entered into long-term, fixed-charge contracts with its interstate and intrastate suppliers for the right to have gas delivered to the plant. (Tr., Vol. II, Walker, at 375). As the evidence indicates, these fixed capacity related charges do not vary according to the consumption of natural gas by the plant. (*Id.*)

The Company proposes an adjustment to include in base rates, rather than in fuel costs, the fixed capacity charges that SCE&G must pay for upstream natural gas transportation capacity to serve Plant Urquhart. Based on the fixed nature of these obligations, the Commission finds that it is appropriate that these charges be included in base rates. Doing so, the Commission finds, will help to properly segregate the fixed charges of the plant from the variable charges that are related to the intensity of its use. (Tr. Vol. II, Walker, at 375). Doing so should also lead to greater stability in annual fuel factors computed under *S.C. Code Ann.* §58-27-865 (Supp. 2002) and will allow the Company to better match the true variable cost of operating the plant with system economics and opportunities for market sales.

The fixed capacity related charges in question total $8,510,386 per year. (Tr. Vol. II, Walker, at 374). The Commission orders that this amount be reflected in electric operating expenses for rate making purposes and that the retail portion of this amount ($8,081,000) shall be deducted from the fuel cost recovery under *S.C. Code Ann.* §58-27-865. As the actual retail-related capacity charges vary from year to year and are added to the fuel cost calculation, they will be netted against the fixed deduction, such that variations, positive or negative, will be reflected in the fuel costs calculated under *S.C. Code Ann.* §58-27-865.

To account for this change in the method of recovery of these costs, the Company is further ordered to reduce the fuel cost recovery factor established in Order No. 2002-347 by $0.00044/kwh. This reduction shall take effect on the effective date of the rates approved herein. The amount of the reduction reflects the per kilowatt hour effect of deducting $8,081,000 in expenses from the fuel cost approved in Order No. 2002-347.

9. JASPER PROJECT CWIP

SCE&G is currently constructing a new 875-MW natural gas fired generating plant in Jasper County South Carolina. (Tr., Vol. I, Lorick, at 39). Construction has been underway since the Spring of 2002, pursuant to Order No. 2002-19, issued by this Commission in Docket 2001-420-E, approving the siting of the plant. (*Id.*).

Construction of the Jasper plant is proceeding under a fixed-price, turn-key contract between SCE&G and Duke/Fluor Daniel. (Tr., Vol. II, Walker, at 271-72). This contract contains schedule and performance guarantees, and fixed, milestone-based payment schedules, that are fully comparable to the contracts under which Duke/Fluor Daniel recently built the Cope Generating Station for SCE&G. (*Id*; Vol. V, Marsh, at 1673-74).

(a) THE COMPANY'S PROPOSED TREATMENT OF CWIP

The Company has asked the Commission to allow it to include in rates the Construction Work in Progress (CWIP) related to the Jasper Project through December 31, 2002. At that time, payments under the Duke/Fluor Daniel contract, and related carrying costs and internal Company costs, will have increased the total Jasper Project CWIP from the $148,142,435 on the books as of June 30, 2002, to $276,224,951. (Tr., Vol. II, Walker, at 376). The Company proposes that the Staff will audit the CWIP balances after that date and that new rates will not go into effect until Staff determines that the full $276,224,951 has been properly expended on the project. (Tr., Vol. V, Marsh, at 1674).

The Commission agrees that the amount of $276,224,951 of Jasper Project CWIP should be included in rates in this proceeding, subject to audit by the Commission Staff as set forth above. This decision is in keeping with the Commission's decisions concerning CWIP related to the Cope Generating Station, as reflected in orders in Docket Nos. 92-619-E and 95-1000-E. Specifically, in Order No. 93-465, issued in Docket No. 92-619-E, the Commission discussed the benefits of such an approach to CWIP in great detail.[3] The reasons given there still have force, and the Commission reaffirms the findings of that order. (*See* Tr., Vol. V, Marsh, at 1675-76).

(b) BENEFITS OF THE COMPANY'S CWIP PROPOSAL

The Commission finds that allowing this additional CWIP into rates will stop the accrual of carrying costs on the full $276,224,951 of investment at issue. (Tr., Vol. V, Ellison, at 1473). These carrying costs, which accrue as Allowance for Funds Used During Construction (AFUDC), would otherwise be capitalized as additional costs of the facility. These costs would then become part of the Company's rate base and revenue requirements until fully depreciated over the life of the project.

Allowing this CWIP to be reflected in rates now will reduce the ultimate cost of the plant by the full amount of the carrying costs at issue. This reduction in the cost of

[3] The assertion by the Consumer Advocate's witness, Mr. Watkins, that established precedent required the CWIP to be cut off by September 30, 2002 is not correct. (Tr., Vol. IV, Watkins, at 1057). The orders sited indicate that the level of expenditures included in rates were levels reached only after the hearing in the case and within a matter of weeks of the effective dates of the rates in question. Order No. 93-465 at 43; Order No. 96-15 at 11.

the plant will reduce the amount of revenue that the Company will need to recover to support its investment in the plant. Accordingly, customers will benefit by lower rates during the full useful life of the plant.

In addition, the Commission finds that allowing $276,224,951 of Jasper Project CWIP to be placed into rates in this proceeding does several other important things:

First, allowing this investment into rates now will improve the quality of the Company's earnings at a time when earnings quality is very important to the financial health of utility companies. AFUDC represents non-cash "paper" earnings. Analysts historically have not favored such paper earnings in their analysis of the financial health of regulated utilities. In today's markets, the Commission believes that investors will be particularly sensitive to the quality of a company's earnings and allowing this additional CWIP into rates will improve the quality of SCE&G's earnings.

Second, allowing this CWIP into rates at this time will spread the rate impact of revenue requirement related to the new plant more evenly over the plant's construction period. The Commission finds that the alternative would be to defer the CWIP and the related carrying costs for inclusion in rates in future proceedings. This deferral, the Commission finds, would result in higher future rate increases and less opportunity for customers to adjust to additional costs of supplying their growing demands.

Third, allowing this investment into rates now sends a constructive message to investors concerning the eventual inclusion of the project into rates. The Commission finds that sending such a signal will assist the Company in maintaining access to capital on reasonable terms during a period when the Company will be raising substantial capital in national markets. The Commission finds that allowing the Company to access reasonably priced capital during this time will reduce the cost of serving customers over the entire period that the new bonds and shares are outstanding.

The Commission specifically finds that because of the nature of the contracts under which the plant is being constructed, and because of the Staff audit of actual expenditures the Commission is requiring as staff witness Ellison testified, the amounts of CWIP to be included in rates under this Order are fully known and measurable for ratemaking purposes. (*Id.*).

Accordingly, the Commission rules that $276,224,951 of Jasper Project CWIP should be included in rates in this proceeding, subject to Staff audit.

(c) THE SCEUC ARGUMENTS

The witness for the SCEUC, Mr. Phillips, argued in his testimony that the additional CWIP related to Jasper should not be included in rates in this proceeding for reasons related to (a) the nature of the plant as a combined-cycle gas plant, (b) the present economic conditions of the nation, (c) the size of the plant, and (d) his assertion that the plant is not used and useful at present. We address each of these arguments in turn.

<u>The Nature of the Plant</u> – Mr. Phillips notes that combined cycle natural gas generation plants have relatively low capital costs. (Tr., Vol. IV, Phillips, at 1227). However, the record shows that the Jasper Plant will in fact cost more in nominal dollars

than did the Cope Plant for which this treatment for CWIP was initially granted.[4] The Commission finds that the relative capital costs are not a basis for treating the Jasper CWIP differently from CWIP related to other plants.

In addition, Mr. Phillips notes the relatively short construction cycle of the Jasper Plant as a reason to treat its CWIP differently from other plants. The record shows that, the Jasper Plant will have a 38 month planning and construction cycle. (Tr., Vol. V, Lorick, at 1644). While this time period is shorter than that of a coal-fired generating station, the Commission determines that it is still a significant period of time over which to accrue carrying costs on project expenditures.

The Commission finds that given this 38 month construction cycle, there are substantial benefits to the CWIP treatment requested here. In fact, the Company's CFO calculated that the effect of not adding any of the Jasper CWIP to rates would be to increase the ultimate cost of the plant by $64 million and increase by $9 million the annual revenue requirement of the plant that would be charged to customers. (Tr., Vol. V, Marsh, at 1701). The Commission finds this testimony to be credible and probative of the benefits of the CWIP treatment the Company is proposing.

Present Financial Conditions – Mr. Phillips points to difficult financial conditions as a reason not to allow the proposed treatment of CWIP. (Tr., Vol. IV, Phillips, at 1227). However, these conditions must be viewed in light of the long-term interest of all parties. The Commission believes that it is of great importance, in light of the adverse conditions in financial markets today, that the Company preserve its access to capital on

[4] Compare Tr., Vol. I, Lorick, at 39 (total Jasper Plant cost is $478 million) with Order No. 95-15 at p. 10 (total Cope Plant cost was $436 million).

reasonable terms. Such access will allow it to maintain a reliable, efficient electric system on which all business in its service territory depends. Including the additional CWIP for Jasper in rates at this time is in the best interest of the Company and its customers for that reason.

The Size of the Jasper Plant – The final point Mr. Phillips raises is his assertion that the Jasper plant is sized larger than currently needed. However, the record shows that even with all CWIP through December 31, 2002, in rates, only 58% of the total cost of the plant will be borne by customers. (Tr., Vol. V, Lorick, at 1644). Moreover, the Commission finds that the plant was properly designed to take advantage of valuable economies of scale in its construction. The record shows that building the third Jasper unit at this time has reduced the cost of the plant by $111 million, compared to the cost of building two units presently and adding a third later. (*Id.* at 1645). Moreover, the record shows that the third unit will be needed to serve retail demand in 2006 and that the procurement of equipment for it would have had to have begun before the present construction was complete. (*Id.*). Finally, the Company has been able to sell 250 MW of system capacity to third parties based on the reserves Jasper will represent when it comes on line. (*Id.*). Customers will be credited 100% of the value of this sale. (*Id.* at 1645, 1654, 1698).

Accordingly, the Commission reaffirms its finding in the Jasper siting order that the Jasper Plant is properly sized and that customers will receive substantial benefits from the decision to build all three units at this time. Order No. 2002-19 at pp. 4-5, 14. The

Commission does not find that the size of the Jasper Plant provides a justification for not allowing the Company's requested CWIP treatment.

The Used and Useful Nature of the Plant – Mr. Phillips also suggests that the Company's investment in the Jasper Plant is not used and useful and so should not be included in rates. Under South Carolina law, property that is prudently acquired for future utility use is properly included in rate base. *See Southern Bell Tel. & Tel. Co. v. Public Service Commission*, 244 S.E.2d 278, 282 (S.C., 1978). In addition, the Commission has consistently held that CWIP related to projects prudently undertaken and managed to provide utility service is indeed used and useful and properly included in rate base. Such is the case with the Jasper Project.

The issue is well settled in South Carolina that CWIP is properly included in rate base. The only question here is whether the full amount of the known and measurable investment in the Jasper Project should be included in rates in this proceeding. The Commission finds that sound regulatory policy, existing precedent, and the evidence on the record all supports inclusion of CWIP in the amount of $276,224,951 in rates subject to Staff audit.

10. CASH WORKING CAPITAL

Part of the capital required to operate a utility or other business is the capital needed to meet the business's cash requirements. As the record shows, there are two principal methods recognized by regulatory commissions for measuring the amount of cash working capital needed to operate regulated utilities. The one-eighth method calculates cash working capital by taking one-eighth of the utility's designated Operating and Maintenance expenses. The Commission has employed the one-eighth method pursuant to a directive to regulated utilities, dated November 13, 1974. That directive sets forth both the one-eighth method as the required method of calculating working capital and sets forth the categories of O&M expenses to which it applies.

The alternative method to the one-eighth formula is the use of lead-lag studies. Lead-lag studies are studies which attempt to measure the utility's working capital needs by measuring the lead times between receipt of goods and services by the utility and payment for them, and by measuring the lag between utility's provision of service and payment of the resulting bills by the customer. (Tr. Vol. II, Walker, at 387-88). Lead-lag studies for enterprises as complex as electric utilities are time consuming and expensive. (*Id.*; Vol. V, Ellison, at 1459). In addition, such studies require many subjective decisions to be made concerning how to characterize revenues and expenses and how to correlate costs with revenues. (Tr., Vol. II, Walker, at 387-88). The result is that such studies are rarely conclusive and tend to reflect the bias of the experts who produce them.

(a) REQUEST TO ORDER A LEAD-LAG STUDY FOR THE NEXT RATE PROCEEDING

No party has objected to the use of the one-eighth formula in this proceeding. The Consumer Advocate's witness, Mr. Watkins, however, has requested that the Commission order the Company to undertake a lead-lag study for determining cash working capital in its next rate proceeding. (Tr., Vol. IV, Watkins, at 1062-63).

In 1989, the Commission reviewed the results of a lead lag study that it had ordered SCE&G to perform along with all other electric and gas utilities under its jurisdiction. In that proceeding, the Commission found that the one-eighth formula provided comparable results to a properly conducted lead lag study and that "the expense and effort to prepare such a [lead-lag] study did not justify its utilization." Order No. 89-588, p. 39.

The Commission addressed the issue again in Order No. 93-465 (p. 36-37), where it ruled as follows:

> [T]he one eighth formula is a proper means to determine cash working capital. One reason is practicality. The lead-lag study is extremely complex and expensive. A utility company, like SCE&G, generates millions of bills for services each year and pays thousands of bills from suppliers. If the Commission were to order lead-lag studies, SCE&G's customers would ultimately pay the cost of them. Moreover, the outcome of the studies is very much dependent on the assumptions used in labeling and tracking expenditures. . . .[U]tility companies are uniquely well-suited for application of a standard formula for cash-working capital purposes.

In this proceeding, the expert accounting witness for the Company, Mrs. Walker, testified that "[t]he justifications for not conducting such [lead-lag] studies are equally applicable today as they were in past cases." (Tr., Vol. II, Walker, at 388).

The record here does not contain any evidence indicating that the conclusions reached in the prior orders no longer apply. The record provides the Commission with no reliable, credible or probative evidence on which to conclude that new lead-lag studies would, in fact, produce benefits that outweigh the simplicity, clarity and efficiency gained by continuing to rely on the one-eighth formula. In this regard, the Commission finds that the citation to magazine articles concerning cash conversion analyses by the Navy's witness, Mr. Coates, does not provide a credible basis for drawing conclusions concerning matters as complex, subjective and sensitive as cash working capital requirements. (Tr., Vol. II, Coates, at 335, 342). The Commission declines to order such a study and reaffirms its ruling in Order No. 93-465.

(b) APPLICATION OF THE ONE-EIGHTH FORMULA TO *PRO FORMA* ADJUSTMENTS

In employing the one-eighth formula, the Company applied it initially to its per books statement of test year O&M expenses. Then, as it made *pro forma* adjustments to those per books expenses, the Company computed related revisions to its cash working capital requirements to reflect the impact of those *pro forma* changes on cash working capital needs. (Tr., Vol. II, Walker, at 389). This process ultimately produced a calculation of cash working capital that took into account the elimination of unallowable, non-recurring or atypical test year expenses. The calculation also took into account known and measurable changes to test year expenses. Consistent with recent Commission precedent, however, the Staff applied the formula on a per books basis and to adjustments that corrected the Company's books. Staff's calculations had the effect of keeping cash working capital on a per book basis. (Tr., Vol. V, Ellison, at 1476).

The Commission agrees with the method employed by the Staff because per book amounts represent actual expenditures for the test period. The Staff's method is more representative of the actual cash requirements of the utility during the test period.

(c) CHANGES TO THE ONE-EIGHTH FORMULA

The Witness for the Navy, Donald Coates, testified that the Commission should change the universe of O&M expenses to which the one-eighth formula should apply. He specifically suggested that the Commission exclude from the one-eighth calculation fossil fuel costs and related costs, and costs related to uncollectible accounts. (Tr., Vol. II, Coates, at 335-36).

However, for the reasons set forth in the testimony of the Company's witness, Mrs. Walker, the Commission finds that these expenses are indeed expenses to which cash working capital is required and should be part of the cash working capital calculation. (Tr., Vol. II, Walker, at 383-86). In addition, the Commission finds that the method of applying the cash working capital formula it has used in past cases, and has determined to be accurate through its resulting experience, requires inclusion of the expenses Mr. Coates would exclude in the calculation. To exclude these expenses, the Commission finds, would call into question the accuracy of the proven formula that it has historically used and uses properly in the present case.

In addition, Mr. Coates bases his proposal on the working capital calculation as applied by FERC. The Commission finds, as Mrs. Walker testified, that the FERC approach involves a number of other differences in how working capital is calculated. (Tr., Vol. II, Walker, at 454). These other differences would increase the level of working capital the Company would be allowed, where the elements Mr. Coates chose to suggest would all decrease it. The Commission concludes that it would not be proper to appropriate parts of the FERC approach without regard to the other elements that may well make the approach, in total, produce a reasonable result. (*Id.* at 454-55).

11. NUCLEAR DECOMMISSIONING COST

Neither the Consumer Advocate, Dr. Ruoff, nor any of the other witnesses presented any testimony concerning an adjustment to the Company's nuclear decommissioning costs. Accordingly, no proposed adjustment was placed before the Commission and parties for discussion, comment or rebuttal at the hearing.

However, the Consumer Advocate and Dr. Ruoff propose that the Company terminate collection from ratepayers for nuclear decommissioning expenses, taking into account inflation in costs and earnings from the investment of the decommissioning trust fund. *See* Joint Brief of the Consumer Advocate and Dr. John C. Ruoff at 4. This is based on those two parties' conclusion that the Company has already collected adequate money to fund its future decommissioning expenses, taking into account inflation in costs and earnings from the investment of the decommissioning trust fund. We reject the adjustment and the propounded reasoning, since there is no basis in the record to support this finding. Although the Consumer Advocate attempted to bolster the record with documentation on decommissioning expenses, he did not demonstrate that the Company collected adequate funds for its future decommissioning expenses.

12. ADJUSTMENT TO PENSION INCOME

As the record indicates, the return on the Company's pension plan assets in the last several years has exceeded the cost of accruing future pension benefits for employees. (Tr., Vol. II, Walker, at 370). This level of return has allowed the Company to recognize income from the plan rather than expense. (*Id.*). As a result, the Company recorded $16,292,735 in pension income for the test period. (*Id.* at. 371). However, due to recent downturns in the stock market, the Company will be able to record only $5,350,032 in pension income in calendar year 2002. (*Id.*). The Company has proposed a *pro forma* adjustment to test year expenses to reflect this decrease in pension income of $10,942,703. (*Id.* at 370).

The Navy's witness, Donald Coates, argued against this adjustment on the basis that the Company's "proposal is no better predictor of future Pension (Income) Expense than what was actually recorded in the test year." (Tr., Vol. II, Coates, at 337). The Commission, however, finds that the pension income reflected in the Company's proposed adjustment is not a "proposal" but reflects the amount that the Company is, in fact, required to book during 2002 based on Financial Accounting Standard No. 87 ("FAS 87"). (Tr., Vol. V, Marsh, at 1670-71). Under FAS 87, companies are required to book pension expense or income based on actuarial studies conducted by certified actuaries. (*Id.* at 1671). These studies measure anticipated future pension liabilities, present plan asset levels, and likely levels of future plan income. (*Id.*).

The Commission finds that the Company's proposed adjustment to pension income of $10,942,703 is based on the current actuarial study under which the Company is operating, conducted by the firm of Towers Perrin. (*Id.*). The Commission finds that this actuarial study is based on reasonable assumptions, which if in error at all, underestimate the erosion in the plan's long-term value. (*Id.* at 1671-72).

The Commission further finds that under FAS 87, pension income or expense is never based on "actual experience." Instead, pension expense is always based on the best available actuarial measurement of anticipated future expenses and anticipated future assets. Accordingly, the most accurate measure of pension income or expense is the most current, validly-conducted actuarial study. The Commission therefore reaffirms its ruling in Order No. 93-465 that "the test year pension expense should be based on the latest actuarial study. . . . [T]his annualization is appropriate and is also consistent with the treatment of pension expense by other regulatory commissions." Order No. 93-465 at 14.

Based on this ruling, the Commission finds that the adjustment to pension income proposed by the Company is proper.

13. RATE BASE TREATMENT OF STORM DAMAGE RESERVE FUNDS

In Order No. 96-15 at pp. 61-66, the Commission authorized the Company to establish a storm damage reserve as an alternative to acquiring insurance for distribution and transmission facilities not otherwise covered under standard casualty insurance policies. The storm damage reserve was authorized as an alternative to the expensive, inadequate or risky insurance coverage available against such losses on the market. Order No. 96-15 at 61-62. In this proceeding, no party has challenged the propriety of the storm damage reserve itself. The accounting witness for the Consumer Advocate, however, has proposed a change in the way that the storm damage funds are accounted for on the books of the Company. (Tr., Vol. IV, Watkins, at 1064).

It is long-standing policy that the Company's shareholders should not earn a return on capital they have not supplied. Accordingly, the Commission generally requires the Company to deduct from rate base any customer-supplied funds it may hold, including customer deposits, contributions in aid of construction, customer pre-payments and the like. In many cases, customer-supplied funds are subject to State and Federal income tax. Accordingly, the Commission has required the funds held net of the related tax payments to be deducted from rate base to reflect the actual amount of customer-supplied funds held by the Company.

Under the State and Federal tax laws, funds collected from customers for the storm damage reserve are taxable income to the Company when received. As it requires with other customer-provided funds, the Commission requires the Company to credit against rate base the net amount of the storm damage funds collected after taxes. (Tr., Vol. 2, Walker, at 393).

The Consumer Advocate's witness, Mr. Watkins, proposes that the Company credit the pre-tax amount of the storm damage funds collected from customers against rate base. (Tr., Vol. IV, Watkins, at 1064). Mr. Watkins does not dispute that the funds collected are in fact subject to tax, nor does he dispute the amount of funds actually available for credit against rate base is \$16.8 million (gross collections of \$27.2 million net of taxes of \$10.4 million). (Tr., Vol. II, Walker, at 393). However, Mr. Watkins asks the Commission to order the Company to credit the full amount of \$27.2 million against rate base. (Tr., Vol. IV, Watkins, at 1064-65).

For the reasons set forth in the testimony of the Company's witness, Mrs. Walker, the Commission finds that this proposal violates the fundamental principle that deductions from rate base to reflect customer contributed capital should reflect the actual net amount of capital received by the Company from customers. (Tr., Vol. II, Walker, at 393-94).

In addition, the Commission rejects Mr. Watkins' argument that the Company is unfairly insulated from all storm damages. The Company is, in fact, liable for the first \$2.5 million in storm damages in any given year. Moreover, the Commission has historically allowed utilities to accrue the prudent and necessary costs of major storms as regulatory assets and to amortize them in future rates. The storm damage reserve established in Order No. 96-15 changes the timing for recovery of such costs by allowing those costs to be collected over time in advance of a storm. The mechanism thereby protects customers and the Company from unexpected and potentially disruptive rate increases that might otherwise be necessary to cover catastrophic storm damage. The Commission, however, cannot agree with the Consumer Advocate that the benefits to all parties that this mechanism provides somehow constitute a justification for denying the Company's shareholders a return on part of their investment in the Company.

The Commission Staff is proposing to allocate all of the storm damage reserve to the Company's retail operations. Staff's adjustment is a reduction to rate base of \$264,000. Further Staff proposes to true-up the storm damage reserve to reflect the actual amount of the reserve at the end of the test period. Staff's adjustment reduces rate base by \$76,000. Staff's proposals are consistent with Order No. 96-15, and we therefore approve Staff's adjustments. *See* Tr., Vol. V, Ellison, at 1479.

14. NON-ALLOWABLES

The Commission Staff, the Consumer Advocate and the Navy have all proposed the removal of various non-allowables from the cost of service, such as institutional and good will advertising, civic club dues, donations, service awards, employee newsletters, and other miscellaneous items that are not considered necessary expenses for ratemaking purposes. The Commission has reviewed the testimony of all parties and finds that the Staff's proposed total company adjustment of $762,000 is the appropriate adjustment for these non-allowable items. (Tr., Vol. V, Ellison, at 1478). This amount includes a civil penalty of $101,000. We believe that the Staff's proposal most accurately identifies the proper amount of non-allowables removable from cost of service. The Commission notes that in keeping with established precedent, the Staff has proposed removal of one-half of the dues associated with the Company's membership in the Chamber of Commerce. (*Id.*). The Commission finds that the Chamber of Commerce is an organization useful for recruiting industry into South Carolina, and so benefits the State to the extent that one-half of the dues for the Chamber are properly recognized for rate-making purposes in this proceeding as well.

15. SALUDA DAM REMEDIATION

SCE&G is in the early stages of a project to strengthen the Saluda Dam against the danger of failure due to earthquakes. This project is being undertaken pursuant to orders of the FERC which regulates dam safety for hydroelectric projects of such size.

Owing to the early stages of the Saluda Dam Remediation Project, the Company is not seeking to include related construction work in progress in rates at this time. Instead, it has proposed an adjustment to remove the initial amounts of CWIP related to this project from rate base for the purposes of this proceeding. (Tr., Vol. II, Walker, at 377). However, the Company is careful to point out that it does intend to include project-related investments and expenses in Quarterly Reports to the Commission and does not waive the right to seek rate recovery of these amounts in future proceedings. (*Id.*).

No party has objected to these adjustments or requests. The Commission finds them to be appropriate and hereby grants them without prejudice to the Applicant or to any party as to the issues that may be raised in future proceedings concerning this project and the investments related to it.

16. MISCELLANEOUS *PRO FORMA* ADJUSTMENTS PROPOSED BY THE APPLICANT

The Applicant has proposed *pro forma* adjustments, in addition to those discussed more specifically above, as follows:

a. Annualizing the effect on retail operations of its new sale-for-resale contract with the City of Greenwood (Tr., Vol. II, Walker, at 366);

b. Decreasing test year expenses to remove expenses related to capacity purchases that are no longer required (*Id.*);

c. Adjusting the level of uncollectible accounts to reflect unusual levels of write-offs during the test year (*Id.* at 367);

d. Removing costs and investments related to Employee Clubs (*Id.*);

e. Annualizing changes in Service Company cost allocations (*Id.*);

f. Annualizing nuclear plant security and maintenance expenses (*Id.* at 368);

g. Annualizing base salary expense and related taxes (*Id.*);

h. Annualizing OPEB expense and related adjustments to rate base (*Id.* at 370);

i. Updating plant in service to reflect additions and retirements up to June 30, 2002 (*Id.* at 371);

j. Updating depreciation reserves to June 30, 2002 (*Id.*);

k. Annualizing current depreciation rates (*Id.*);

l. Adjusting amortization expense to reflect items fully written off during the test period (*Id.* at 372);

m. Annualizing the impact of plant additions on property taxes (*Id.* at 373);

n. Updating CWIP balances to June 30, 2002 (*Id.*);

o. Placing the full amount of the Urquhart Project plant in service into rate base to reflect commercial operation of the plant, along with adding depreciation, property taxes and maintenance related O&M expenses into expenses (*Id.* at 373-74);

p. Reducing rate base by the value of synthetic fuel tax credits earned as of June 30, 2002 (*Id.* at 380); and

q. Decreasing income tax expense by the reduction in income taxes associated with the *pro forma* adjustments allowed to rate base. (*Id.* at 381).

The Commission finds these *pro forma* adjustments to be proper for the reasons stated in the testimony of the Company's accounting witness that is referenced above. The Commission further finds that, in calculating final rates under this Order, these proposed adjustments should be revised to reflect the Commission's specific rulings contained elsewhere in this Order and to reflect the other corrections to these adjustments proposed by the Staff and not contested by the Applicant.

17. STAFF AND OTHER ADJUSTMENTS

The Commission Staff has proposed a number of other adjustments to which the Company consents or did not oppose. Those included:

a. An adjustment to reduce property, plant and equipment balances related to the investment in the Urquhart Repowering Project (Tr.,Vol. V, Ellison, at 1467-71);

b. An adjustment to reflect the 12 month average of material and supplies in rate base (*Id.*);

c. An adjustment to reduce O&M expense related to property taxes which produces a net adjustment to the Company's figures of $1,477,000 (*Id.* at 1471, Vol. II, Walker, at 394);

d. An adjustment related to OPEB true ups (Tr., Vol. V, Ellison, at. 1480); and

e. An adjustment for customer growth using Staff's growth factor of 1.05% (Hearing Exhibit 45, Audit Exhibit A-2).

The Commission finds these *pro forma* adjustments to be proper for the reasons stated in the testimony of Mr. Ellison that is referenced above and as limited and modified by specific rulings contained elsewhere in this Order.

The Commission holds that all other accounting and *pro forma* adjustments proposed by the Commission Staff, and not objected to by other parties, are approved. Further, all other adjustments proposed by other parties, which are not specifically addressed herein, have been considered by the Commission and are denied.

D. EVIDENCE AND CONCLUSIONS REGARDING YEAR END ORIGINAL COST RATE BASE

(FINDING OF FACT NO. 11)

Pursuant to *S.C. Code Ann.* Sec. 58-27-180 (1976), the Commission has the authority after hearing to "ascertain and fix" the value of the property of an electric utility. In the context of a ratemaking proceeding, such authority is exercised in the determination of the electric utility's rate base.

For ratemaking purposes, the rate base is the total net value of the electric utility's tangible and intangible capital or property value on which the utility is entitled to earn a fair and reasonable rate of return. The rate base, as allocated or assigned directly to SCE&G's retail electric operations, is composed of the value of SCE&G's property, used and useful in providing retail electric service to the public, plus net nuclear fuel, construction work in progress, materials and supplies, and allowance for cash working capital. The rate base computation incorporates reductions for the reserve for depreciation and amortization, accumulated deferred income tax and customer deposits. In accordance with its standard practice, the Audit Department of the Commission Staff conducted an audit and examination of SCE&G's books and verified all account balances from SCE&G's General Ledger, including rate base items, with plant additions and retirements. (Tr., Vol. V, Ellison, at 1451; Hearing Ex. 45). On the basis of this audit, pertinent hearing exhibits, and testimony contained in the record of the hearing, the Commission can determine and find proper balances for the components of SCE&G's rate base, as well as the propriety of related accounting adjustments.

For ratemaking purposes, the Commission has traditionally determined the appropriate rate base at the end of the test period. This Commission's practice of determining a utility's rate base on a "year end" basis serves to enhance the timeliness of the effect of such action and preserves the reliance on historic and verifiable accounts without resort to speculative or projected figures. Consequently, the Commission finds it most reasonable to continue to adhere to this regulatory practice and evaluate the issues of this proceeding using a rate base for SCE&G's retail electric operations as of March 31, 2002.

When the rate base has been established, SCE&G's total operating income for return is applied to the rate base to determine what adjustments, if any, to the present rate structure are necessary to generate earnings sufficient to produce a fair rate of return. The rate base should reflect the actual investment made by investors in SCE&G's property and the value upon which stockholders will receive a return on their investment.

With respect to the record in the instant proceeding, only certain rate base issues were contested by the parties of record. Those issues related to plant in service and construction projects and to the methodology for computation of working capital and are each discussed separately in the previous section of this Order. The Commission hereby adopts the following as the Company's rate base:

TABLE B
ORIGINAL COST RATE BASE
RETAIL ELECTRIC
MARCH 31, 2002
(000'S)

	$
Gross Plant in Service	4,730,816
Accumulated Depreciation	(1,586,439)
Net Plant	3,144,377
CWIP	474,438
Accumulated Deferred Income Taxes	(461,697)
Materials & Supplies Inventory	136,762
Total Working Capital	1,822
Deferred Debits/Credits	(121,619)
Total Original Cost Rate Base	3,174,083

E. EVIDENCE AND CONCLUSIONS REGARDING COST OF CAPITAL

(FINDINGS OF FACT NOS. 12, 13, 14)

1. COST OF EQUITY

(a) LEGAL STANDARDS

In setting rates, the Commission must determine a fair rate of return that the utility should be allowed the opportunity to earn after recovery of the expenses of utility operations. The legal standards applicable to this determination are set forth in *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591, 602-03 (1944) and *Bluefield Water Works and Improvement Co. v. Public Service Commission of West Virginia*, 262 U.S. 679, 692-73 (1923). These standards were adopted by the South Carolina Supreme Court in *Southern Bell Telephone and Telegraph Co. v. South Carolina Public Service Commission*, 244 S.E. 2d. 278, 281 (S.C. 1978).

Specifically, *Bluefield* holds that:

> What annual rate will constitute just compensation depends upon many circumstances, and must be determined by the exercise of a fair and enlightened judgment, having regard to all relevant facts. A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. A rate of return may be reasonable at one time and become too high or too low by changes affecting the opportunities for investment, the money market and business conditions generally.

Bluefield Water Works and Improvement Co. v. Public Service Commission of West Virginia, 262 U.S. at 692-73, as quoted in *Southern Bell Telephone and Telegraph co. v. South Carolina Public Service Commission*, 244 S.E. 2d. at 281. In addition, these cases establish that the process of determining rates of return requires the exercise of informed judgment by the Commission. As the South Carolina Supreme Court has held, quoting *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. at 602-03:

> the Commission was not bound to the use of any single formula or combination of formulae in determining rates. Its ratemaking function, moreover, involves the making of 'pragmatic adjustments'. . . . Under the statutory standard of 'just and reasonable' it is the result reached not the method employed which is controlling. . . . The ratemaking process under the Act, i.e., the fixing of 'just and reasonable' rates, involves the balancing of the investor and the consumer interests.

Southern Bell Telephone and Telegraph Co. v. South Carolina Public Service Commission, 244 S.E. 2d. at 281. This is in keeping with the general rule that "[r]atemaking is not an exact science, but a legislative function involving many questions of judgment and discretion." *Parker v. South Carolina Pub. Service Commission*, 313 S.E.2d 290, 291 (S.C. 1984).

These principals have been employed by the Commission and the Courts of this State consistently since their adoption in 1978. They continue to provide the appropriate standards to guide the Commission's determination of rates of return in proceedings such as this one. From these authorities, the Commission derives the following specific points to guide its evaluation of the evidence in this case:

1) The rate of return should be sufficient to allow SCE&G the opportunity to earn a return equal to firms facing similar risks;
2) The rate of return should be adequate to assure investors of the financial soundness of the utility and to support the utility's credit and ability to raise capital needed for on-going utility operations at reasonable cost;
3) The rate of return should be determined with due regard for the present business and capital market conditions facing the utility;
4) The rate of return is not formula-based but requires an informed expert judgment by the Commission balancing the interests of shareholders and customers.

Finally, the Commission notes that "[t]he determination of a fair rate of return must be documented fully in its findings of fact and based exclusively on reliable, probative, and substantial evidence on the whole record." *Porter v. South Carolina Public Service Commission,* 504 S.E.2d 320, 323 (S.C. 1998) citing *S.C. Code Ann.* § 58-5-240 (Supp. 2002); accord S.C. Ann. § 58-27-870(G) (Supp. 2002).

(b) OVERVIEW OF THE TESTIMONY

The starting point for the determination of SCE&G's cost of capital is a review of the testimony of the witnesses who used financial models to measure required equity returns numerically. In all, four witnesses testified as to the appropriate cost of capital for SCE&G based on the use of financial models. Those witnesses were

- Burton G. Malkiel, Ph.D., the Chemical Bank Chairman's Professor of Economics at Princeton University who testified on behalf of SCE&G. Dr. Malkiel is former Chairman of the Economics Department of Princeton, former Dean of the Yale Business School, and a former member of the President's Council of Economic Advisors. He is a member of the Board of Directors and Chairman of the Investment Committee of Prudential Securities Company and is a Member of the Board of Directors of Vanguard Group of Investment Companies. (The latter companies have a combined investment portfolio of $1 trillion.) Dr. Malkiel has published extensively on finance issues both in the academic and popular press;
- David C. Parcell, MBA, Executive Vice-President and Senior Economist, with Technical Associates, Inc. who testified on behalf of both the Consumer Advocate and the South Carolina Merchant's Association;
- Michael Gorman, MBA, a consultant with Brubaker & Associates, Inc. who testified on behalf of the South Carolina Energy Users Committee; and
- James E. Spearman, Ph.D., the Commission Staff's Research and Planning Administrator.

In addition, Thomas R. Osborne, Managing Director in the Global Energy and Power Group of UBS Warburg, LLC's Investment Banking Department, testified on behalf of SCE&G concerning conditions in national capital markets and the group of comparable companies he selected and provided to Dr. Malkiel as an input to Dr. Malkiel's calculations. Finally, Kevin Marsh, SCE&G's Senior Vice President and Chief Financial Officer, testified on the present business and market conditions that the Company is facing and concerning the flotation costs the Company has incurred in issuing new capital.

Summary results of the financial analyses conducted by the four witnesses who offered opinions regarding SCE&G's equity capital are as follows:

RESULTS	WITNESS			
	Dr. Malkiel	Mr. Parcell	Mr. Gorman	Dr. Spearman
DCF	12.3%[5]	10.5%-11.0%[6]	11.2%[7]	7.74%-12.65%[8]
Risk Premium	Not accepted but as high as 13.5%[9]	Not Used	9.9%-11.4%[10]	8.4% -12.4%[11]
CAPM	Rejected[12]	10%-10.5%[13]	9.4%[14]	8.06% – 10.61%[15]
Comp. Earnings	Not used	11.0%[16]	Not used	Not used
Flotation Adjustment	0.20%[17]	Not Included	Not Included	0.20%[18]
Recommendation	**12.5%**[19]	**10.5%**[20]	**10.5%**[21]	**11.95 - 12.45%**[22]

[5] Tr., Vol. III, Malkiel, at 803.
[6] Tr., Vol. IV, Parcell, at 1107.
[7] Tr., Vol. IV, Gorman, at 1177.
[8] Tr., Vol. V, Spearman, at 1585.
[9] Tr., Vol. III, Malkiel, at 820 (when adjusted for company size).
[10] Tr., Vol. IV, Gorman, at 1172-73.
[11] Tr., Vol. V, Spearman, at 1585.
[12] Tr., Vol. III, Malkiel, at 814-17.
[13] Tr., Vol. IV, Parcell, at 1107.
[14] Tr., Vol. IV, Gorman, at 1177.
[15] Tr., Vol. V., Spearman, at 1585.
[16] Tr., Vol. IV, Parcell, at 1107.
[17] Tr., Vol. III, Malkiel, at 805-06.
[18] Tr., Vol. V, Spearman, at 1587.
[19] Tr., Vol. III, Malkiel, at 808.
[20] Tr., Vol. IV, Parcell, at 1107.
[21] Tr., Vol. IV, Gorman, at 1177
[22] Tr., Vol. V, Spearman, at 1587.

(c) REVIEW OF THE METHODOLOGIES

(i) CAPITAL ASSET PRICING MODEL ("CAPM")

Three of the four witnesses, Mr. Parcell, Mr. Gorman and Dr. Spearman, performed a CAPM analysis as one of several tools to measure the Company's cost of equity capital. As the chart above shows, the CAPM model consistently produced the lowest rates of return of any of the models. Mr. Parcell's CAPM analysis produced a return of 10.0% to 10.5% while Mr. Gorman's produced a return of only 9.4%. Dr. Spearman's produced a range of 8.06% – 10.61%.

The Commission finds that the reliable, probative and substantial evidence on the record demonstrates that, in the present economic conditions, the CAPM model does not accurately measure the required rates of return for companies like SCE&G. Dr. Spearman rejected a rate of return for SCE&G in the range produced by the CAPM model (8.06% to 10.61%) because he did not believe that investors would invest in SCE&G if its returns were set in that range. (Tr., Vol. V, Spearman, at 1606). As discussed more fully below, the Commission agrees with Dr. Spearman's conclusion: reasonable expectations of returns in the markets are indeed greater than those indicated by the CAPM model. (*Id.*).

In addition, the Commission finds reliable and probative Dr. Malkiel's conclusion that an absolute floor for investor expectations of returns for a company of the size and risk profile of SCE&G in today's market is above 11.8%. (Tr., Vol. III, Malkiel, at 802-03). Dr. Malkiel arrived at this conclusion by measuring the market returns on a group of utilities with market capitalizations approximately five times that of SCE&G. (*Id.* at 802). He found that the value that the market actually placed on their shares created an

11.8% return on equity for these companies. (*Id.*). The Commission finds, as discussed more fully below, that comparable larger companies are perceived to be less risky, not more risky, than comparable but smaller companies and therefore such larger companies may enjoy lower costs of capital than smaller companies. (*Id.* at 824).

Accordingly, the Commission finds that the reliable, probative and substantial evidence on the record establishes that a minimum return for SCE&G must be higher than 11.8% in present market conditions. (Tr., Vol. III, Malkiel, at 802). The Commission also finds that the results of the CAPM model, when measured against present economic conditions and investor's expectations, does not produce credible results.

The Commission also finds credible the testimony of Dr. Malkiel that the empirical evidence and research raises questions concerning the theoretical assumptions underlying the CAPM model. (*Id.* at 839-41). The CAPM model employs a measure of a stock's volatility relative to the broader market, called beta. On the basis of the beta, the CAPM model attempts to calculate the company's risk and market's required return for taking on that risk. The validity of beta as an indicator of required return is at the heart of the CAPM model. (*Id.* at 839). Recent research, however, has shown that betas are not stable, and they cannot be accurately measured. (*Id.* at 815). More importantly, a number of recent and important studies in the finance literature have shown that beta and return are essentially uncorrelated. (*Id.* at 815-17, 839-41; Vol. IV, Malkiel at 917-18). These later findings are unchallenged in the record here.

Based on this evidence, the Commission finds that CAPM is not a reliable basis for measuring return in this proceeding. The Commission notes that this decision is based on the record before it in this proceeding, and does not foreclose parties from advancing testimony using CAPM in future cases, or from addressing the concerns raised about this analytical tool in future dockets.

(ii) COMPARABLE EARNINGS

The Consumer Advocate's witness, Mr. Parcell, utilized a method called Comparable Earnings to measure SCE&G's earnings. (Tr., Vol. IV, Parcell at 1136). This method attempts to correlate rates of return with book-to-market ratios. (*Id.*). The record shows that there are several reasons to doubt both the accuracy of the method and the conclusions drawn from it.

First, the reliable, probative and substantial evidence on the record indicates that analyses based on book values are inherently questionable. As Dr. Malkiel testified, book values depend on an individual company's policies with respect to depreciation, with respect to write-offs, and with respect to other accounting practices. (Tr., Vol. III, Malkiel, at 829). These policies are not comparable from company to company. (*Id.*). The Commission finds this testimony to be persuasive and credible.

Second, the Commission finds that Mr. Parcell's Comparable Earnings analysis does not sufficiently support his conclusion that 11% is the appropriate rate of return for SCE&G. Mr. Parcell begins his analysis by determining the earnings of the companies that he has selected as being comparable to SCE&G in terms of book to market ratios.

His analysis indicates that these comparable companies have experienced "historical returns of 11.8-13.2 percent" and "projected returns on equity for 2002, 2003 and 2005-2007 are within a range of 11.5 percent to 14.3 percent for the comparison groups." (Tr., Vol. IV, Parcell, at 1138-39).

Mr. Parcell justifies his 11.0% return recommendation by assuming that any return that would allow a stock to trade above book value is a fair rate of return under the standard of *Hope* and *Bluefield, supra.* (Tr., Vol. IV, Parcell, at 1137). However, the *Hope* and *Bluefield* opinions do not concern themselves with book values. Instead, they require that rates of return for utilities be comparable to those of businesses facing similar risks. Mr. Parcell's own analysis shows that the group of comparable companies he has chosen (a) enjoys book-to-market value ratios substantially greater than 100% and (b) enjoys rates of return in a range from 11.5% to 14.3%. (Tr., Vol. IV, Parcell, at 1138-39). Moreover, his analysis also indicates that an 11% return on equity for SCE&G would lead to an immediate and substantial drop in market value, since it would serve to bring the historical 155% to 166% market-to-book ratio to a level "of at least 100%." (Tr., Parcell, Vol. IV, at 1138, 1140; Vol. III, Malkiel, at 829).

For the reasons stated above, the Commission finds that Mr. Parcell's Comparable Earning analysis does not support the 11% return recommendation he derives from it. If the analysis has any meaning, it would appear to support a range of returns from 11.5% to 14.3%. Mr. Parcell's analysis affirmatively demonstrates that a return of 11% or less would result in a substantial and disruptive drop in the company's stock values. The

Commission finds that this analysis contradicts his recommendation, and that of Mr. Gorman, that a 10.5% return would be a fair return under *Hope* and *Bluefield, supra.*

(iii) RISK PREMIUM

Mr. Gorman and Dr. Spearman conducted risk premium analyses as part of their review of SCE&G's cost of capital. Dr. Spearman's analysis produced results in the range of 8.4% to 12.4%, before flotation adjustment. (Tr., Vol. V, Spearman, at 1584-85). Mr. Gorman's analysis produced results in the range of 9.9% to 11.4%. (Tr., Vol. IV, Gorman, at 1172-73).

Dr. Malkiel testified that he had considered, but rejected, the use of a risk premium analysis as an appropriate means of measuring SCE&G cost of equity capital. (Tr., Vol. III, Malkiel, at 819). However, he further testified that if such an analysis were to be conducted, he would not employ beta as an adjusting factor in light of the demonstrated lack of validity of betas as indicators of required returns. (*Id.* at 819-20).

In addition, Dr. Malkiel testified that a risk premium analysis concerning SCE&G would need to account for the small size of SCE&G in comparison to the market generally and the resulting perceived increase in risk. (*Id.*). Recent studies in the finance field and long-term data concerning actual market returns show that there is a very strong correlation between company size and required return, with smaller companies requiring substantially higher returns than larger ones. (Tr., Vol. III, Malkiel at 819-20; Vol. IV, Malkiel, at 885-88, 917-18).

Dr. Malkiel then demonstrated that a standard risk premium analysis, relying on long term market data, and not adjusting for beta, would produce an indicated return of approximately 12% before flotation adjustment, a figure substantially greater than Mr. Gorman's point estimate of 10.8% based on his risk premium method. (Tr., Vol. III, Malkiel, at 819-20). Further, adjusting the 12% return number for the small size of SCE&G relative to the market would produce a return of approximately 13.5%, which is much greater than the 12.3% return recommended by Dr. Malkiel based on his DCF methodology. (*Id.*).

A review of Mr. Gorman's testimony establishes that Mr. Gorman's analysis does not account for the impact of company size on market perception of risk and required return. (Tr., Vol. IV, Gorman, at 1171-73). In addition, Mr. Gorman's analysis is based on a relatively short time frame (15 years) while Drs. Spearman and Malkiel present calculations based on a full 75 years of market data. (*Compare* Tr., Vol. IV, Gorman, at 1172 with Tr. Vol. III, Malkiel, at 819-20; Vol. V, Spearman, at 1584-85; Exhibit 48 (JES-10)). Mr. Gorman provides no explanation as to why he chose to use only data from 1986 forward or why it would not be preferable and more accurate to use the much larger data set that is readily available.

Furthermore, Mr. Gorman's calculation of returns specific to the utility sector does not consider actual reported utility returns, but instead is based exclusively on a compilation of the average returns authorized by utility commissions for the years in question. (Tr., Vol. IV, Gorman, at 1172; Exhibit 40, Schedule 5). There is no evidence showing why use of authorized return data is preferable to the actual returns markets have required. Nor is their any evidence to correlate those authorized returns with the returns that capital markets have, in fact, required or to compare these rates to market returns of companies facing similar risks. Under *Hope* and *Bluefield*, it is the reasonable return requirements of capital markets that this Commission is directed to consider as a principal factor in setting returns.

For these reasons, the Commission does not believe that Mr. Gorman's analysis and the 10.8% return conclusion that he draws from it represent a reliable basis on which to establish a rate of return for SCE&G. The Commission further notes that the upper end of the risk premium range of returns calculated by Dr. Spearman's analysis (12.4%) is based on an analysis that (a) uses long-term data, (b) uses actual return information, and (c) does reflect the higher return requirement associated with smaller companies. (Tr., Vol. V, Spearman, at 1584-85; Exhibit 48 (JES-10)). Dr. Spearman's analysis does, however, adjust its results downward substantially for beta. (Tr., Vol. V, Spearman, at. 1171-1172; Exhibit 48 (JES-10)). Without the beta adjustment, Dr. Spearman's analysis could support a return much higher than 12.4%.

Based on this evidence, the Commission finds that risk premium analyses does indeed support a cost of equity capital, before flotation adjustment, in the range of 12% or higher.

(iv) DISCOUNTED CASH FLOW MODEL ("DCF")

The DCF model ("DCF" or "Gordon Model") measures investors' return requirements by correlating a Company's stock price with the present value of its anticipated earnings stream and through this analysis, to determine the rate of return assumptions embedded in that relationship. (Tr., Vol. III, Malkiel, at 794-95). As the testimony indicates, the Gordon model works particularly well for determining the required rates of return for public utilities, particularly in economic circumstances like those at present. (*Id.* at 798).

All four cost of capital witnesses used the DCF model to estimate SCE&G's cost of equity capital. By design, Dr. Spearman's results covered the broadest range (7.74%-12.65% before flotation adjustment), since he included the broadest range of alternative calculations in his analysis. Dr. Malkiel employed a single DCF calculation based on the assumptions that he found most reasonable and accurate. His calculation showed a tight grouping of returns around a 12.3% return on equity before flotation adjustment. (*Id.* at 801). Mr. Gorman conducted a somewhat similar analysis with a different group of comparable companies from those used by Dr. Malkiel. He concluded that the DCF model indicated 11.2% as an appropriate cost of capital for SCE&G. (Tr., Vol. IV, Gorman, at 1177). Much of the difference between Mr. Gorman's return and Dr. Malkiel's return can be attributed to the different earnings growth rates used in their DCF models. Mr. Gorman used an average earnings growth rate of 5.25% compared to Dr. Malkiel's average earning growth rate of 6.6%. Mr. Parcell conducted a DCF analysis using a different group of comparable companies and a very different measurement of anticipated future growth rates. Mr. Parcell averaged a number of different growth rates to derive the 4.3% growth rate used in his DCF model. His DCF analysis indicated a return in the range of 10.5% to 11% would be appropriate for SCE&G. (Tr., Vol. IV, Parcell, at 1131).

Earnings Growth vs. Dividend Growth – A key input in the DCF analysis is the estimated future earnings stream of the company. One way of measuring future earnings is to use analysts' estimates of the company's future growth in earnings per share. These estimates are provided in publications by financial services firms like I/B/E/S, First Call and others. (Tr., Vol. III, Malkiel, at 797, 802-03). This is the approach Dr. Malkiel and Mr. Gorman used, and which Dr. Spearman used for that part of his DCF analysis he found to be most credible.

Another approach is to use estimates of future dividend growth as the growth rate in the DCF analysis. (Tr., Vol. V, Spearman, at 1577-78). As one of his alternative calculations, Dr. Spearman performed a DCF calculation for SCE&G using anticipated dividend growth as his growth factor. The results showed a cost of equity for SCE&G of between 7.75 - 9.01%. (*Id.* at 1585). No party supported a cost of equity for SCE&G in such an extremely low range. Dr. Spearman did not base his recommendations on the results of this analysis, testifying that analysts' predictions of earnings growth are the principal data on which investors rely and include dividend growth to the extent relevant. (*Id.* at 1615). In addition, Dr. Spearman rejected as unrealistic returns in the range produced by this analysis. (*Id.* at 1621).

The Commission finds that the reliable, probative and substantial evidence on the record establishes that in present economic circumstances a DCF analysis based exclusively on dividend growth rates does not provide a reliable basis on which to measure SCE&G's equity capital costs. Again, the Commission notes that this decision is based on the record before it in this proceeding, and does not foreclose parties from advancing testimony using dividend growth DCF in future cases, or from addressing the concerns raised about this analytical tool in future dockets.

Historical and Constructed Growth Rates – Mr. Parcell used an average of various historical, prospective, and constructed growth rates, including earnings retention growth, book value growth, dividend growth, and earnings growth as the growth factor in his DCF analysis. (Tr. Vol. IV, Parcell, at 1130). The problems arising from the use of dividend growth have been discussed. Book values may not be comparable across companies as previously discussed. Also, there is no theoretical foundation for using book value growth as the growth factor in the DCF model. The use of retention earnings growth as the DCF growth rate has more validity as it is a means of measuring earnings growth. Analysts may, in fact, consider all of these factors when forecasting future returns. However, there is no basis for merely aggregating these factors and averaging them to derive a growth rate for the DCF model.

The Commission also finds persuasive the testimony of Dr. Malkiel concerning the most appropriate growth rate for the DCF analysis for purposes of this proceeding. He testified that his own work

> and the work of Fama-French and Myron Gordon confirm that growth rates projected by securities analysts are the most reliable tool for estimating the cost of equity capital using a DCF analysis. Further, my own work and Dr. Gordon's work have demonstrated that a DCF analysis using analysts' growth rates is the most direct, most widely used and accepted, and most reliable model in use in corporate finance today to estimate a company's cost of equity capital.

(*Id.* at 830). Drs. Malkiel and Spearman concur that investors rely heavily on analysts' forecasts of earnings growth when making investment decisions. For these reasons, the

Commission finds that the most reliable DCF model in this proceeding is the earnings growth DCF model.

Comparable Companies – Because SCE&G stock is not publicly traded, each witness selected a comparison group of companies. Dr. Malkiel used a group of electric utility companies selected by Mr. Osborne as comparable to SCE&G. Mr. Gorman selected a group of six utility companies that he considered comparable to SCE&G. Mr. Parcell selected a group of five companies that he considered comparable to SCE&G. Dr. Spearman selected seventeen companies comprising the Moody's Electric Utility Index as his comparison group. The differing return-on-equity recommendations of the witnesses appeared to be the result of the model inputs and not the comparison groups. Specifically, the different results occurred primarily from the different growth rates used in the DCF analyses. The return-on-equity estimates produced by the DCF analyses would be very close to each other if the same growth rates were used by each witness. Since the choice of comparison group seemed to have little impact on the return-on-equity recommendations of the witnesses, the Commission sees no need to favor one comparison group over another in this case.

Conclusions Concerning the Numerical Analyses – The Commission finds that the reliable, probative and substantial evidence on the record demonstrates that the earnings growth DCF analyses performed by Drs. Malkiel and Spearman are appropriate and reliable numerical analyses to use in evaluating required market returns for SCE&G in this proceeding. Dr. Malkiel's analysis produced a return of 12.3% while Dr. Spearman's analysis produced returns in the range of 10.61% to 12.65%.

The Commission further finds that the results of these DCF analyses are confirmed by risk premium analyses based on long-term data, actual return data, and similar sized companies. According to Dr. Malkiel, the risk premium analysis produced a 12% return which should be adjusted to 13.5% to reflect the small size of SCE&G. The corresponding risk premium analysis performed by Dr. Spearman produced a return as high as 12.4%.

Weighing the results of the reliable and probative numerical analyses, the Commission finds that the substantial evidence on the record of this proceeding supports a return on equity for SCE&G, before flotation adjustment, in the upper end of the range calculated by Dr. Spearman of 10.61% to 12.65% derived from his DCF analysis using earnings growth. This range encompasses the upper end of Dr. Spearman's return derived from his risk premium analysis and Dr. Malkiel's recommended return of 12.3%. (Tr., Vol. V, Spearman, at 1579-80, 84-85).

(d) ESTABLISHMENT OF A COST OF EQUITY CAPITAL (BEFORE FLOTATION ADJUSTMENT)

Having reviewed the financial modeling data provided by the witnesses, the Commission now reviews the other factors established by *Hope* and *Bluefield* to be relevant to its determination of an appropriate cost of capital for SCE&G. Specifically, those cases require:

1) That the rate of return should be adequate to assure investors of the financial soundness of the utility and support the utility's credit and ability to raise capital needed for on-going utility operations; and

2) That the rate of return should be set with due regard to current business and capital market conditions affecting the utility.

Bluefield Water Works and Improvement Co. v. Public Service Commission of West Virginia, 262 U.S. at 692-73, as quoted in *Southern Bell Telephone and Telegraph Co. v. South Carolina Public Service Commission*, 244 S.E. 2d, at 281.

Capital Markets – The Commission finds that the reliable, probative and substantial evidence on the record shows that the capital market conditions facing SCE&G are difficult and tumultuous. (Tr., Vol. III, Osborne at 732, 736, 753, 780; Vol. IV, Malkiel, at 894-96; Vol. V, Spearman, at 1586-87). In the wake of recent high profile business bankruptcies and near failures--several of which are in the energy sector--stock markets have become, in Dr. Malkiel words, "incredibly volatile." (Tr., Vol. III, Malkiel at 894).

Regulated utility companies that were once seen as a group as safe, secure investments are now viewed with skepticism by investors. (Tr., Vol. I, Marsh, at 166-67). As Dr. Spearman testified, lingering uncertainty about the pace and course of regulatory change is seen as a major risk for electric utility companies in today's markets. (Tr., Vol. V, Spearman, at 1612). As Mr. Osborne further testified:

> Unfortunately, the entire power sector, and not only those companies engaged in unregulated energy activities, is now being viewed by investors as entailing more risk. Consequently, the power sector as a whole, and each individual company, must provide sufficiently high returns to continue to attract investor capital.

(Tr., Vol. III, Osborne, at 753).

Based on the evidence in the record in this regard, which is more extensive than that quoted here, the Commission finds that the market conditions support the choice of a rate of return for the Company at the higher end of the range established above.

Business Conditions – The Commission finds that SCE&G is facing business conditions that make it particularly sensitive to conditions in financial markets and investors' concerns about the risks of the energy sector. The record shows that SCE&G must spend $961 million during the next two years to add new generating capacity to its system, to provide environmental and safety upgrades to existing facilities, and to make other improvements or additions to its facilities. (Tr., Vol. I, Marsh at 161, 170). SCE&G has recently issued $550 million from the capital markets over the current three year period. (*Id.*).

The Commission finds that the Company has historically sought to maintain a single-A bond rating and that rating is presently in jeopardy. (*Id.* at 179). The Commission finds to be credible and persuasive the testimony of SCE&G's CFO, Mr. Marsh, that as a result of several major business failures, rating agencies have become more stringent in their expectations and unyielding in applications of their rating standards. (*Id.* at 164-65, 179). The evidence shows that SCE&G does not fully meet the financial targets for its single-A status at present and will lose that rating if the rates approved under this order do not generate earnings sufficient to improve its debt coverage ratios. (*Id.* at 163-65, 179).

Accordingly, in assessing the business conditions facing the Company, the Commission finds that the reliable, probative and substantial evidence on the record shows that SCE&G's credit ratings are in jeopardy and that the Company's ability to raise money on reasonable terms to support the proper discharge of its public duties may be at risk. These facts support a cost of equity capital at the high end of the range discussed above.

Balancing of Interests – The South Carolina courts have held that the setting of rates of return "involves the balancing of the investor and the consumer interests." *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. at 602-03, quoted in *Southern Bell Telephone and Telegraph Co. v. South Carolina Public Service Commission*, 244 S.E. 2d. at 281. The evidence on the record here shows that were SCE&G's debt rating to drop to BBB the result would be to add substantially to the cost of the $550 million in new financing SCE&G must raise over the next two years. (TR at vol. I, pp. 165, 170). Specifically, over the life of a 30 year bond such a rating drop would add $1.05 in additional financing costs to each $10.00 financed, or $58 million of additional financing costs to $550 million in new bonds. (*Id.* at 165, 170). Clearly, shareholders and customers share an interest in maintaining SCE&G's access to capital on reasonable terms during this period of high capital needs for the Company and volatile and unyielding conditions in financial markets. To do otherwise could substantially increase the Company's debt service costs for decades and could substantially increase costs to customers for an equal length of time.

Conclusion – Determining the appropriate return on equity is more than a numerical calculation. Many factors must be considered when deriving the appropriate return. In the end, the Commission is convinced that the most prudent, just and reasonable response to the financial evidence, to present business and market conditions, and to the interrelated interests of the Company and its customers, is to set a rate of return for the utility at high end of the return-on-equity range (11.75% - 12.25%) proposed by Dr. Spearman. (Tr., Vol. V, Spearman, at 1585-87). A return of 12.25% before flotation adjustment is well within the 12.65% upper end of Dr. Spearman's DCF analysis and the 12.4% upper end of his risk premium analysis. It also fits well within Dr. Malkiel's analysis showing that much larger companies are earning average returns of 11.8% and SCE&G's proper return must be substantially higher than 11.8%. Dr. Spearman's recommended return is only slightly lower than the 12.3% return recommended by Dr. Malkiel. (Tr., Vol. III, Malkiel, at 802).

The Commission also finds that this return on equity should provide the Company an opportunity, with sound management, to retain its access to capital on reasonable terms and to support and maintain its credit. Setting a return on equity capital at this level should indicate to investors and potential investors in SCE&G that their continued investment in the electric and gas infrastructure on which this State depends will be treated fairly by this Commission, and that their reasonable return expectations will be respected. The Commission believes that this rate of return properly balances the interests of investors and customers and furthers the long term interests of both groups by helping the Company maintain its debt rating and thereby reduce its long term cost of debt service.

(e) FLOTATION ADJUSTMENT

A flotation adjustment is an upward adjustment to the cost of capital to reflect the cost of issuing, or "floating," new capital. The adjustment reflects (a) the fact that flotation of new capital incurs substantial cost and (b) as an accounting matter, those costs are not otherwise recovered in rates. It has been the practice of the Commission in past cases to allow applicants to recover a flotation adjustment where a flotation of new equity has taken place in the recent past or is planned during the next three years. (Tr., Vol. V, Spearman, at 1587). Both Drs. Malkiel and Spearman and the Applicant's CFO, Mr. Marsh, testified in support of the need for an acquisition adjustment for SCE&G in this proceeding. Mr. Marsh further established, through reliable and probative testimony, that these costs are held on the Company's balance sheet as a permanent deduction from the balance of capital received from investors and are not treated as expenses, amortized or otherwise included in rates. (Tr., Vol. V, Marsh, at 1702-03). Dr. Spearman noted that when a Company issues equity, the issuance negatively impacts the stockholders of the Company. The issuance drives down the price of the stock and lowers the earnings per share, which makes it more difficult for the Company to increase dividends. In order to compensate for this decline to the stockholders, a flotation adjustment is made. (Tr., Vol. V, Spearman, at 1633). Drs. Malkiel and Spearman both quantified the amount of the adjustment for SCE&G as an additional 20 basis points (0.20%). (Tr., Vol. III, Malkiel at 807-09; Tr., Vol. V, Spearman, at 1587).

The Commission makes the following specific determinations concerning flotation costs:

The On-Going Nature of Flotation Cost – The Consumer Advocate suggested, in its cross-examination of Dr. Malkiel, that allowing a flotation cost adjustment to be included in the Company's cost of capital would result in over-recovery of flotation costs. He suggests that the full value of the flotation costs would be recovered in the first year, and a duplicative recovery would result for every succeeding year thereafter. (*Id.* at 865).

The Commission finds that this line of argument misconstrues the nature of a flotation adjustment. As the reliable, probative and substantial evidence on the record shows, flotation costs are not an expense to be recovered during a particular period. Instead, they represent a difference in the amount of funds that investors have invested in the Company compared to the amount the Company actually receives. In other words, if flotation costs equal 4.25% percent of the capital raised, then for every $1.00 contributed by an investor, the Company receives $0.9575 in capital. For investors to earn a given return on their $1.00 investment, the company must earn a higher return on the $0.9575 held in rate base.

Upon cross examination by Commissioner Atkins, Dr. Spearman explained that existing stockholders, unlike bondholders, are penalized when new common stock is issued. Stockholders give a company money in return for dividends and common stock. The stockholder expects both the dividend and the price of the stock to increase over time. When new stock is issued, the stock price decreases and earnings per share decreases. Both of these are detrimental to existing stockholders. A decrease in stock price lowers the value of the existing stockholders investment. A reduction in earnings per share puts downward pressure on future dividend payouts as more earnings are required to pay dividends. The reduction in earnings per share also hinders future stock appreciation. (Tr. Vol.V, Spearman, at 1632-1634). The negative impact of stock dilution resulting from the issuance of new common stock continues until the number of shares outstanding returns to its pre-issuance level. A stock flotation adjustment is required to compensate existing stockholders for this dilution.

Amount of the Flotation Adjustment – Both Drs. Malkiel and Spearman recommended a 20 basis point flotation adjustment. The Commission is encouraged that the differing methodologies used by Dr. Malkiel and Dr. Spearman produced identical results. Dr. Malkiel's methodology determines the stock flotation adjustment based on the percentage of the sales revenue of the common stock that is actually received by the company. Dr. Spearman's methodology determines the stock flotation adjustment based on DCF returns before and after the new stock was issued. His methodology measures the actual market reaction to the stock issuance. The Commission finds the methodology used by Dr. Spearman and his recommended 20 basis point adjustment to be appropriate in this case.

Accordingly, the Commission finds that the reliable, probative and substantial evidence on the record establishes that flotation adjustments are indeed appropriate in this case to reflect SCE&G's recent issuance of new equity and the fact that these costs are not otherwise recovered in setting rates. The Commission finds that an adjustment of 20 basis points is in fact appropriate to ensure that the return investors actually receive for the funds invested in the Company equals the return that the Commission establishes with reference to the Company's rate base.

(f) TOTAL GRANTED RATE OF RETURN ON EQUITY

The addition of the approved rate of return on equity without flotation costs of 12.25% and the 20 basis points flotation cost yields a total approved rate of return on equity of 12.45%.

2. CAPITAL STRUCTURE

In keeping with established Commission practice, the Staff has updated the Company's capital structure and cost of debt and preferred stock, to reflect the figures current at the time of the Staff's recent audit and included the October 16, 2002, issuance of $150,000,000 of common stock. (Tr., Vol. V, Spearman, at 1460). These underlying figures are not in dispute. Witnesses Malkiel, Gorman, and Spearman recommended capital structures consisting of long-term debt, preferred stock, and common equity.

The Consumer Advocate's witness Mr. Parcell, however, has argued that the Commission should depart from its long-standing practice of setting cost of capital based on long-term obligations, and has proposed that the Commission insert into the cost of capital analysis consideration of the Company's short-term debt.

The Commission, however, finds persuasive the testimony of Dr. Malkiel who testified that the rates and levels of short-term debt fluctuate significantly due to multiple, short-term factors, such as the impending maturities of long-term debt, and current levels of accounts receivables. Dr. Malkiel further testified that "[t]o include short-term debt [in cost of capital calculations] will tend to distort the company's true cost of financing its business operations since capital projects are financed through either equity or long-term debt." (Tr., Vol. III, Malkiel, at 832). The Commission finds this testimony to be reliable and probative and finds that the substantial evidence on the record support using long-term debt and equity as the basis for computing the Company's capital costs.

3. EMBEDDED COST RATE OF LONG-TERM DEBT AND PREFERRED STOCK

The Commission's determination concerning the amount and cost of long-term debt and preferred stock is based on the embedded rates of those instruments as shown in the Company's books and records. The rates used are the actual rates in force on September 30, 2002, determined subject to the Staff audit of the Company's books and records. The values are as shown in Finding of Fact No. 13.

F. EVIDENCE AND CONCLUSIONS CONCERNING RATE DESIGN (FINDINGS OF FACT NO. 15, 16)

1. GENERAL PRINCIPLES

Upon the identification of revenue requirements, the Commission is responsible for determining specific rates and developing a rate structure that will yield required revenues. It is generally accepted that proper utility regulation requires the exercise of control over the rate structure to insure that equitable treatment is afforded each class of customer.

The Commission's statutory responsibility to fix "just and reasonable rates" [*S.C. Code Ann.* §§ 58-3-140, 58-27-810 (1976)] has been exercised by the recognition of the objective to provide a utility a fair opportunity to earn a reasonable return, which meets the established revenue requirement and equitably apportions the revenue responsibility among classes of service. In discharging the Commission's responsibility to fix "just and reasonable rates," we have traditionally adhered to the following criteria:

> ...(a) the revenue-requirement or financial-need objective, which takes the form of a fair-return standard with respect to private utility companies; (b) the fair-cost-apportionment objective, which invokes the principle that the burden of meeting total revenue requirements must be distributed fairly among the beneficiaries of the service; and (c) the optimum-use or customer-rationing objective, under which the rates are designed to discourage the wasteful use of public utility services while promoting all use that is economically justified in view of the relationships between cost incurred and benefits received.

Bonbright, *Principles of Public Utility Rates* (1961), p. 292.

These criteria have been consistently observed by this Commission and again are utilized here.

The cost of supplying electricity to different customer classes is a function of many factors and variables. The allocation of these costs among the different classes of customers represents a complex task. The procedure generally used by this Commission in analyzing utility costs in the context of the review of rate design provides for the distribution of total costs among three major categories: (1) costs that are a function of the total number of customers, (2) costs that are a function of the volume of the service supplied (energy costs), and (3) costs that are a function of the service capacity of plant and equipment in terms of their capability to carry hourly or daily peak loads (demand costs).

In concluding that rates should be based on cost of service principles, the Commission espouses the economic theory that regulation is intended to act as a surrogate for competition by insuring that each rate that is charged for electricity is fair and reasonable. That is, that utility rates are maintained at the level of costs, including a fair return on capital. By incorporating cost of service principles, the Commission provides for rates and charges which are designed to promote equity, engineering efficiency (cost-minimization), conservation and stability.

Company witness, John Hendrix, discussed the Company's adherence to the foregoing principles in its processes for developing rates. His testimony consisted of three major subject areas: cost of service, rate design, and general terms and conditions. Mr. Hendrix sponsored the utility's cost study and supported the resultant rates and charges. (Hearing Ex. 17 [JRH-2]); (Tr., Vol. II, Hendrix, at 464).

2. COST OF SERVICE STUDY

The foundation for an equitable and efficient, cost-based rate structure is a cost of service study, which accounts for the variables and factors from which are derived the costs of supplying electricity to different classes of customers. The cost of service study not only identifies the total cost of service and thereby measures the profitability of the utility, but also identifies cost by function and class of service, and so measures the compensability of service to any one customer class. Furthermore, the cost of service study is used to assess the propriety of any one particular rate structure in the design of rates. In a sense, a cost of service study functions as a regulatory guide by which the ratemaker can determine the existing rate of return of each class and the manner and extent to which it should be adjusted to achieve cost-based rates.

The principal steps in developing the cost of service study are the functionalization of costs, classification of cost, and allocation of costs. (*Id.* at 465). Functions include production, transmission, and distribution. Classifications are identified as customer, demand, and energy. The final step in the process is the allocation of costs to classes of service. (*Id.* at 466).

Customer costs, which vary with the number and size of customers, are direct costs which customers place on the system simply by being connected with a service drop, meter, account, and monthly bill. (*Id.*). Accordingly, the Company developed factors used for allocating billing expenses between customer classes by weighing the average number of customers in the class by the average time to read a typical meter for customers in that class and the average time required to develop billing determinants for customers in that class.

Demand costs are the fixed costs of building and operating the system required to serve the Company's customer base. The cost of service study utilizes two basic demand allocators. The coincident peak allocator was developed based on the system territorial four-hour peak demand. The non-coincident peak allocator was developed by combining the non-coincident peak demands of each class of customers when they were incurred during the test year. (*Id.* at 467; Tr., Vol. V, Watts, at 1509).

The energy allocator was developed from the annual kilowatt hour-sales by class of customer adjusted for system losses. The Company collected data on energy usage by customer class and used actual test period data in making this allocation. (Tr., Vol. II, Hendrix at 468).

Following classification, the revenue, expense and rate base items were allocated according to function or purpose. (*Id.* at 466; Tr., Vol. V, Watts, at 1509). This process is essential to a fair allocation of revenue requirements for the utility system, which requires the separation of costs associated with each customer class and with the utility's jurisdictional operations.

The Company's cost of service study, utilized in the design of the proposed rates and charges, was founded on embedded costs and is based on the cost of service study recommended by the Staff's Utilities Department. (Tr., Vol. II, Hendrix, at 511; Vol. V, Ellison, at 1457). The Commission has consistently relied upon the concept of embedded costs as the starting point in the implementation of ratemaking precepts. There is no evidence in the record of this proceeding to cause the Commission to abandon our well-founded reliance upon the principle of embedded cost as a starting point for determining just and reasonable rates. The Commission hereby reaffirms the Four Hour Band Coincident Peak Methodology for ratemaking purposes, adopted in its Order No. 96-15.

No Intervenor challenged the validity of the Company's cost of service study. (Tr., Vol. II, Hendrix, at 494). The cost of service study presented provides a proper foundation for distributing costs among classes since it recognizes cost causation and distributes costs accordingly. This study also provides a proper basis for determining cost-based rates and is a major component of fair and equitable rate design. The cost of service study also provides a reasonably accurate measure of profitability among classes of customers. (*Id.* at 469). *See* Hearing Ex. 17 (JRH-1 & 2). Accordingly, the Commission hereby approves the Company's proposed cost of service study.

3. ALLOCATIONS AND REVENUE REQUESTS

This Commission has considered it axiomatic that retail rates should produce rates of return among classes which bear a reasonable relationship to the Company's overall rate of return. Further, there should be movement towards equal rates of return among the classes. PSC Order 96-15 (January 9, 1996), Docket No. 95-1000-E, at p. 70. It has been the allocations and revenue requests proposed by the Company which have caused the most concern among the Intervenors.

(a) THE COMPANY'S POSITION

The revenue requested by the Company is based on the rate of return information contained in Exhibit D-11, page 2 of 3 of the Company's Application. This information indicates a need for a net revenue increase of $104,716,000 to compensate the Company adequately for its electric service. As testified by the Company's accounting witness Mrs. Walker, the Company proposes to include in retail rates, and eliminate from the fuel cost recovery calculation, $8,079,000 in annual pipeline fixed capacity charges related to natural gas service to the recently repowered turbines at Plant Urquhart. To reflect this, rates have been created to reflect a total revenue increase from base electric rates of $112,795,000. The matching reduction in fuel cost recovery accomplished by reducing the base fuel rate in the proposed rates from $0.01722 per KWH to $0.01678 per KWH, will create a net increase from the rate adjustments proposed on Ex. 17 of $104,716,000. (The Commission Staff report calculates this amount as $104,714,153. *See* Hearing

Exhibit 45.) The Company requested that, if the Commission approves the fixed capacity charges for inclusion in base rates, the base fuel rate requested be approved also.

In addition to cost of service, other factors guided the Company in designing its rates. These factors were value of service, rate history, revenue stability, improvement of system load factor, and optimum use of natural resources. (*Id.* at 470). Mr. Hendrix acknowledged on cross-examination that his consideration of these factors necessitates the exercise of experienced, subjective judgment. (*Id.* at 512, 526).

The result of the application of the factors utilized by the Company, objective and subjective, was the rate of return relationships set forth in Hearing Exhibit No.17 (JRH-3):

SOUTH CAROLINA ELECTRIC & GAS
CLASS RATE OF RETURN RELATIONSHIPS

	BEFORE INCREASE			AFTER INCREASE	
	RATE OF RETURN	% OF RETAIL ROR	% INCREASE	RATE OF RETURN	RELATIONSHIP
RESIDENTIAL	7.78%	100%	7.06%	9.50%	96%
SMALL	7.12%	92%	13.81%	10.13%	102%
MEDIUM	7.82%	101%	11.94%	10.87%	109%
LARGE	8.50%	109%	5.38%	10.12%	102%
LIGHTING	7.50%	96%	12.82%	10.17%	102%
TOTAL RETAIL	7.78%	100%	8.70%	9.93%	100%

Mr. Hendrix testified that these relationships reflected cost causation and were significant in order to adhere to the Commission's objective of moving toward equal rates of return among classes of customers. Since the Company's last rate case, the peak demand for Medium General Service and Small General Service grew at a faster pace than the overall peak demand. These two classes are adding costs to the system at a higher rate than the other classes. Tr., Vol. II, Hendrix, at 488.

As to shifts in rate of return ratios, since the Company's last rate case, the Residential class had gone from 92% to 100%, Small General Service went from 108% to 92%, Medium General Service went from 106% to 101%, Large General Service stayed the same at 109%, and Lighting went from 100% to 96%. Assuming reasonably that these trends in shifts will continue, the returns in this case are set so that each of the customer classes can move toward 100% until the next time rates are revisited. It would be inappropriate to set them in a way which would permit disparities to grow during the intervening time frame. The Company has historically considered a "reasonable" relationship to be within 10% plus or minus of the overall return. This basic principle has been used by the Company and approved by the Commission for many years, and the principle is appropriate for use in the present proceeding as well. The proposed revenue spread puts all classes of customers within this band of reasonableness. *Id.* at 488-489.

(b) THE INTERVENORS' POSITION

The arguments of the Intervenors essentially challenged the subjective factors relied on by the Company and contended that rates for every customer class should be cost-based. Any subsidies provided by one class to another as a result of rates being set above costs should be eliminated, according to Intervenor witness Higgins. (Tr., Vol. IV, Higgins, at 1202); Vol. V, Higgins, at 1262). Revenues from rates for each particular class of customer should equal the cost of serving that particular class. (Tr., Vol. IV, Higgins, at 1204). SCE&G's proposed rates place a disproportionate and unreasonable burden on customers in the Medium General Service (Tr., Vol. V, Higgins, at 1262) and

Small General Service classes, (Tr., Vol. V, Wilkes, at 1396), according to the Intervenor witnesses. In order to achieve cost minimization (the customer's efficient use of electricity), rates must send appropriate price signals. Deviation from cost-based pricing distorts the signals sent. (Tr., Vol. IV, Phillips, at 1205). Such distortions could adversely affect the state's base of industrial customers and affect the state's ability to attract new industry. (*Id.* at 1224-25). In the alternative, the Intervenor witnesses state that if strictly cost-based rates are not implemented, a new rate spread should be adopted or the Company's proposed spread should be reduced, utilizing any reductions which the Commission might make to the Company's revenue requirement. (Tr., Vol. V, Higgins, at 1267-1275). There was substantial concern voiced by all classes of customers regarding the implementation of any rate increase given the present state of the economy generally.

(c) PSC STAFF POSITION

While making no recommendation as to the amount of revenue to be allowed in this proceeding, the Staff concluded that the methodology applied in constructing the cost of service study continued to provide reasonable apportionment and allocation of the Company's revenues, operating expenses and rate base. (Tr., Vol. V, Watts, at 1517).

(d) CONCLUSION

The Commission is mindful of the implications of a rate increase on any class of customers and, indeed, on any customer. The Commission is also mindful of the requirements of the utilities which it regulates and the need for decisions which strategically balance the needs of a utility and its customers.

SCE&G in this application sought $104,714,153 in additional revenues per the Staff's report. Our rate of return, capital structure, and accounting and pro forma adjustments as described heretofore produce $70,704,000 in additional annual retail revenue, or a reduction of $34,010,153 from the amount proposed. In deciding where to allocate the approved rate increase across SCE&G's various customer classes, we believe that the small and medium general service customers should receive the greatest share of the $34,010,153 reduction. This is somewhat consistent with Intervenor witness Higgins' proposal to earmark the first $4.2 million of any revenue requirements reduction for the Medium customer class. Under Higgins' plan, any reduction beyond that amount should then be spread to all classes of customers in such a manner as to retain the relative return ratios as described in his testimony. *See* Tr., Vol. V, Higgins, at 1274. Further, we believe that this reduction moves the rate of return for the rate classes back towards the 100% benchmark for rate of return among the various classes. Accordingly, we have determined that the rate increase should be distributed across customer classes as follows:

Rate Class	Requested	Approved
Residential	7.06%	5.11%
Small General Service	13.81%	8.00%
Medium General Service	11.94%	8.00%
Large General Service	5.40%	3.89%
Lighting	12.82%	12.82%

Even though the Small General Service and Medium General Service customers are still receiving the largest increases of any of the classes of customers, we would note that our holding results in substantial reductions to these classes from what was originally proposed by the Company. Also, we would state that, since the Company's last rate case, the peak demand for these two classes grew at a faster pace than the overall peak demand, which means that these two classes are adding costs to the system at a higher rate than the other classes. Tr., Vol. II, Hendrix, at 488. Thus, the greater percentage increase to these two classes is justified in this case.

4. BASIC FACILITIES CHARGE

The Company proposes that the Basic Facilities Charge (BFC) for all rates be increased. In his testimony and exhibits, Company Witness John Hendrix demonstrated, without contradiction, that the actual and continuous expenditures necessary to provide customers with the ability to use electricity substantially exceed the proposed BFC. (*See* Hearing Ex. 17 [JRH-4]). We, therefore, find and conclude that the BFC proposed for each customer class is reasonable and approve same.

5. ADJUSTMENT TO RATE 9

The Company has proposed an adjustment to its Rate 9 (General Service) allowing the Company to eliminate the hourly component of the summer demand charge. A demand charge would still apply but would be based on a peak demand greater than 250 KVA set at any point during the day. As explained by Company Witness John

Hendrix, the Company's experience, since the demand charge was previously approved and imposed, reflects that the time-specific demand component of this rate has been difficult to administer because Rate 9 applies to a large, diverse group of customers and also includes a large number of smaller customers. Consequently, it has been difficult to find metering for measuring peaks at certain hours which fit the pricing of the rate and providing useful customer data. No parties have questioned the legitimacy of the Company's request and the Commission finds and concludes that this request is reasonable and hereby approves same.

6. RATES 20, 21, AND 21(A) (STIPULATION)

The Company and the South Carolina Merchants Association (SCMA) have entered into a Stipulation in this case, which involves Rate 20, Rate 21, and a new experimental rate, Rate 21(A). The Stipulation notes that, based on the Commission's determination and approval of the Company's revenue requirement in this case and the amount of increases to be allocated to each customer class to achieve the approved revenue requirement, the Company will revise the design of its filed rates as set forth below in order to achieve the approved revenue requirement by class of customer, based on the Company's test-year billing determinants.

Rate 20 will be re-designed to include a declining tailblock based on the following criteria:

a) The rate will contain two (2) energy blocks as to which energy charges shall apply. The first energy block will apply to all customers with an energy requirement of up to and including 75,000 KWH. The second block (Declining Block) will apply to all customers with an energy requirement in excess of 75,000 KWH.

b) The second energy block (Declining Block) will be designed so that it is equal to 1.035 times the Company's Rate 23 energy margin as approved by the Commission in this docket, plus the Commission-approved fuel rate, plus the storm damage adder for the Medium General Service Class.

c) The first energy block (75,000 KWH and under) will be designed to recover the remaining revenue requirement of this customer class reduced by the revenue received from the Basic Facility Charge, applicable Demand Charge and the Declining Block Energy Charge.

d) The Company will attempt to put as much as possible of any revenue increase approved by the Commission in this docket for the Medium General Service customer class in the Rate 20 demand charge.

The Company's Rate 21 will remain as proposed in the Company's Application. (The Company makes its Rate 21 available to any customer using the Company's standard service for power and light requirements and having a contract demand of 50 KVA and a maximum demand of less than 1,000 KVA.) SCMA witnesses Kevin C. Higgins (Tr., Vol. V, Higgins, at 1278-79) and James Herritage (Tr., Vol. V, at 1366-67) criticized this rate as not sufficiently rewarding high load-factor customers. As explained by Company witness John Hendrix, the rate is not designed to reward customers regardless of their usage, but is designed to provide an incentive by encouraging customers to shift their usage from on-peak to off-peak periods of use thereby reducing system peak demand. Those customers who do not or cannot shift their usage do not benefit under this rate. Generally, since high-load customers are utilizing their demand at or near its full potential, it is difficult for them to shift load to off-peak periods. (Tr., Hendrix, Vol. II, at 484.) The Commission therefore approves Rate 21 as proposed by the Company.

Under the terms of the Stipulation, the Company will develop an experimental Rate 21(A) incorporating the following terms and conditions:

a) Purpose. The purpose of Rate 21(A) is to determine if a discount will encourage medium general service customers to make operational changes resulting in a shifting of peak loads to off peak periods and/or the shedding of peak loads; to determine the extent of these changes in usage; and to determine what, if any, discount is appropriate as a result of reduction of peak load.

b) Eligibility for Participation. This experimental rate is open to any qualifying (as defined below) Rate 21 customer and the first 250 qualifying Rate 20 customers to register, which will comprise the Initial Participating Group.

c) Qualification for Participation. To qualify for participation in this rate experiment, an eligible customer must have recorded a monthly peak demand of 200 KVA or greater at least once during the twelve (12) months preceding that customer's registration for participation.

d) Notice. The Company will notify eligible customers of the rate experiment in the manner prescribed by the Commission. Such notice shall define the registration period for participation and the procedure for registration. Notice shall be given to eligible customers at least 30 days prior to the opening of the registration period.

e) Registration Period. The period for registration will be 30 days, specified in the Notice required above. At the end of the 30 day registration period, the participating group will be closed and no new participants will be allowed, except for a limited number of new facilities as provided for below. Registration may be accomplished through various means, including e-mail, as prescribed by the Commission, or, in the absence of Commission requirements, as agreed upon by the Company and Commission Staff.

f) Expansion of Participating Group. The parties recognize that participating customers may open new facilities during the experiment period and agree that the participating group may be expanded to accommodate at least some of such new facilities. They also recognize that restrictions on new participants, even though affiliated with existing participants, are necessary in order to effectively manage the proposed rate experiment. To accommodate such customer growth, entities in the Initial Participating Group may, in the aggregate, add up to a maximum of 25 new facilities to the experimental rate after the close of the registration period. New facilities will be accommodated on a first come, first served basis, based on the date upon which such added facility can take service under the rate.

g) Term of Rate 21(A) Experiment. The term period for which the Rate 21(A) experiment shall exist is 48 months, calculated as set forth herein. Because of necessary preparations for participation, such as metering, each participating customer will come on the experimental rate at staggered times. Therefore, the term period of the Rate 21(A) experiment will end 48 months after the final customer in the Initial Participating Group receives service under the experimental rate. The parties recognize that this may mean that some participants participate for longer than 48 months, but none will participate less. The term of the Rate 21(A) experiment is unaffected, however, by the entry of participants under the expansion provisions, in paragraph f) above. Expansion participants will only be involved in the experiment for the remaining period of the term as calculated based on the Initial Participating Group. The Company will make a good faith effort to ensure that all customers which register for Rate 21(A) will begin being billed on that rate within six (6) months of the end of the registration period.

h) Obligation to Complete Experiment. A participating customer must agree in writing to remain on Rate 21(A) for the entire term of the experiment, except that a customer which has been on the rate for twelve (12) months and determines that the rate is not beneficial may change to another rate for which the customer qualifies. In the event of such transfer, there will be no refund of excess charges between the new rate and Rate 21(A), if any. Rate 21(A) is non-transferable. If a customer moves to another location, the rate will not follow such customer nor will it apply to that customer's old location or facility.

i) No Guarantee of Results. The parties understand and agree that Rate 21(A) is an experiment, and the Company guarantees no savings to any customer participating in the experiment. Customer-requested comparisons of Rate 21(A) vs. Rate 20 absent actual on and off peak billing determinants will require estimates by the

Company. The Company will use its best efforts to make such comparisons but makes no guarantee of such comparisons or the results of a customer's participation in Rate 21(A).

j) Analysis of Experiment; Report. After the expiration of 48 months of the Rate 21(A) term period, as defined in paragraph g), above, the Company will prepare an analysis of the experiment and file a report with the Commission with recommendations concerning the future of the experimental rate, including whether it should be made permanent, terminated, modified, expanded or continued as an experiment. Rate 21(A) will remain in force until the Commission takes action on the rate following its review of the Report. After final Commission action on the Report, customers participating in the Rate 21(A) experiment may choose any Company rate for which they qualify.

k) Criteria and Guidelines for Designing Rate 21(A). A Profile Customer load will be used to establish a benchmark to measure the amount of savings to be realized from switching to Rate 21(A) from Rate 20. This profile is as follows:

i) 70% annual load factor – annual KWH equals 2,606,100

ii) 500 KVA peak load

iii) 85% Power Factor which would equal 425 KW

iv) 75% Load Factor during on peak periods – summer KWH equals 215,794; winter KWH equals 512,869

v) Off-peak KWH falls out from there – KWH equals 1,877,438

vi) No incremental off-peak KVA

vii) Rate 21(A) will be designed in a way that the Profile Customer above will realize an estimated savings of 4% by moving from the newly-designed declining-tailblock Rate 20 to Rate 21(A).

viii) Based on the final decision of the Commission and the allocation of the revenue increase to classes, the Company will not be obligated to design Rate 21(A) in a manner that would allow any migration from Rate 24.

Further, under the Stipulation, SCMA withdraws all opposition to the Company's request for a 12.5% return on common equity. SCMA also acknowledges that as a consequence of this stipulation and the rate designs discussed above, the Company may experience a loss of revenue.

We have examined the terms of the Stipulation between the Company and SCMA and find them fair and reasonable. Further, we approve the terms of the Stipulation as we find that the rate proposals contained therein appear to be potentially advantageous to the rate classes of customers who are members of SCMA and other businesses as well.

7. TARIFFS AND TERMS AND CONDITIONS OF SERVICE

In its Application, the Company requested a number of changes in its tariffs and terms and conditions of service. The proposals are discussed below.

(a) RECONNECTION CHARGE

The Company proposes to increase the reconnection charge from $15.00 to $25.00 for reconnections scheduled during normal working hours, with an additional charge of $10.00 when the reconnection is requested after normal working hours. (*Id.* at 473-74).

As indicated in the testimony of Commission Staff Witness Mr. Watts (Tr., Vol. V, Watts, at 1512) and Company Witness Mr. Hendrix (Tr., Vol. II, Hendrix, at 474-75), the Company's actual cost in performing reconnections may justify the proposed charges. However, we deny the proposal. We find that, in today's economic conditions, the residential customer would be burdened by such an increase. Clearly, those customers who already have difficulty paying their electric bill would have even greater difficulty with paying an increased reconnection fee to have their electric service reconnected. The proposal for an increase in the reconnection fee is therefore denied.

(b) SECURITY DEPOSITS FROM NONRESIDENTIAL CUSTOMERS

SCE&G requested an amendment to its General Terms and Conditions (Section IV(D)(5)-"Billing and Payment Terms: Deposit") to provide:

> In addition to the above conditions, new or existing non-residential customers may be required to provide a deposit if their credit standing has deteriorated to the extent that, in the judgment of Company, a condition of insecurity is created with regard to present and future payment(s) owed to the Company.

The effect of this amendment is to allow the Company to collect deposits from a non-residential customer whose credit standing has declined to the extent that it creates a condition of insecurity as to that customer's ability to pay for electric service.

We deny the proposal without prejudice. The difficulty with this proposal is the lack of guidelines as to how it would be determined if the credit standing of the non-residential customer has declined to the extent that it creates a condition of insecurity as to a customer's ability to pay for electric service. At present, this non-specificity troubles us greatly. Accordingly, although we deny the proposal at present, we will consider the matter once again when, and if, the Company provides more specific guidelines as to how the deposit would be applied.

(c) DENIAL OR DISCONTINUANCE OF SERVICE

In Sec. III (j) of its General Terms and Conditions, the Company proposes to delete the provisions of paragraph 10 in its entirety and substitute the following language.

> The Company shall not furnish its service to any premises where, at the time of application any person residing at the premises is indebted or any member of the household is indebted under an undisputed bill for service, previously furnished such person or furnished any other member of the person's household or business.

Following paragraph 13, the Company proposes to add

> Failure of the Company to terminate or suspend service at any time after the occurrence of grounds therefore or to resort to any other legal remedy or to exercise any one or more of such alternative remedies, shall not waive or in any manner affect the Company's right to later resort to any or more of such rights or remedies on account of any such ground then existing or which may subsequently occur.

Company witness, John Hendrix, explained that the requested amendment would allow the Company to refuse to provide new service to a premise where members of the household or business have not paid an undisputed bill. Under the present Terms and Conditions, the Company cannot act on the non-payment if the individual applying for the new service to the premises (who may be a landlord or other non-resident) is not the individual listed on the unpaid bill or a member of that individual's household. (*Id.* at 477).

However, as discussed by Staff witness, A. R. Watts, the difficulty with the Company's proposal is developing language which avoids unintended adverse effects on good credit customers. This would arise when a landlord, homeowner, or other third party not residing in the premises is denied service due to the payment record of a renter or other individual living in the premises. Mr. Watts contended that the proposed modification is inconsistent with the Commission's current regulations. (Tr., Vol. V, Watts, at 1511-12). The Commission agrees with Mr. Watts and denies the proposed amendment.

(d) MISCELLANEOUS CHANGES TO GENERAL TERMS AND CONDITIONS

The Company has proposed miscellaneous other changes to its General Terms and Conditions set forth in Exhibits C1 and C2, attached to the Application.

Based on the testimony of Company witness John R. Hendrix and Staff Witness A. R. Watts, there is ample evidence in the record justifying the need and reasonableness of these proposed changes to the General Terms and Conditions, and they are accordingly hereby approved.

G. EVIDENCE AND CONCLUSIONS REGARDING ACCELERATED DEPRECIATION MECHANISM

(FINDING OF FACT NO. 17)

In our Order No. 1999-655 in Docket No. 1999-389-E, the Commission allowed the Company to accelerate depreciation of its Cope Generating Station when revenue and expense levels warranted. When invoked, the Company records additional depreciation related to the Cope facility, which increases expenses and thereby reduces earnings. The mechanism enables the Company to respond to short-term levels of expenses or revenues, without adjustments in rates which would have long-term implications. The Commission maintains at all times the ability to initiate a rate reduction proceeding if it believes that the Company's earnings will be higher than approved levels on a sustained basis. The Company has requested that the Commission extend until December 31, 2005, the period over which it would be able to apply the accelerated capital recovery mechanism, which would otherwise expire on December 31, 2002. Based on the testimony of Company witness Kevin Marsh, the Commission believes this request is in the best interest of the Company and its customers. (Tr., Vol. I, Marsh, at 169). SCE&G ratepayers obtain benefits in that downward pressure is placed on electric rates over the long term: (a) the depreciated book value of the generation rate base used to serve native load customers is reduced and (b) the Company preserves the ability to make ongoing investments in rate base to meet customer and Company needs, without necessarily having to increase rates to recover such investments. In this way, customers obtain the benefit of a reduction in the depreciated book value of the generation rate base used to serve them, the utility becomes more cost-competitive because of the reduction in the net book value of its generating assets, and shareholders and bondholders receive a return on their investment in those assets. Such a mechanism also sustains a stable regulatory environment during the time when the Company experiences an increased level of earnings. (Tr., Vol. V, Marsh, at 1679-80). The Commission agrees with Mr. Marsh, that the reasons supporting the Commission's initial decision regarding this mechanism are still valid today, and the requested extension is hereby granted. The Commission is not persuaded by the testimony of Consumer Advocate witness Watkins that this accounting treatment is "improper" and allows the Company to "misrepresent" its financial results. The Commission will maintain regulatory oversight of this process and finds no basis for these assertions by the Consumer Advocate's witness.

IV.

DECREE

WHEREFORE, it is ordered:

1. That South Carolina Electric & Gas Company shall implement the rate schedules that conform to the finding of this Order for service rendered on or after February 1, 2003, or at such later time that the Staff of this Commission shall verify in writing to this Commission that $276,224,951 of allowable Jasper Project CWIP has been expended.

2. That South Carolina Electric & Gas Company shall within (10) days from its receipt of this Order file with the Commission rate schedules and terms and conditions of service that incorporate the findings in this Order.

3. That this Order shall remain in full force and effect until further Order of the Commission.

BY ORDER OF THE COMMISSION:

Mignon L. Clyburn, Chairman

ATTEST:

Gary E. Walsh, Executive Director

(SEAL)